IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner, Thor Power Tool Co.

Of Counsel:
MAYER, BROWN & PLATT.

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

INDEX

List of Authorities

Cases

Statutes

Treasury Regulations

I.R.S. Ruling

Miscellaneous

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. . . . . .

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petitioner, Thor Power Tool Company ("Thor"), seeks review of the judgment of the United States Court of Appeals for the Seventh Circuit, entered on September 29, 1977. The Court of Appeals, affirming the judgment of the United States Tax Court, held that the Commissioner of Internal Revenue ("Commissioner"), pursuant to the discretion granted him under section 471 of the Internal Revenue Code ("Code"), may require a taxpayer, who values inventory at the lower of cost or market, to carry excess and unsaleable inventory at cost instead of at its actual net realizable value (scrap value), until it is physically scrapped, thereby increasing taxable income by the amount that the cost of the inventory exceeds the scrap value. The Court of Appeals also held that the Commissioner, pursuant to the discretion granted him under section 166(c) of the Code, may limit the taxpayer's reserve for bad debts

to an amount no greater than a 6-year average of the taxpayer's bad debt experience, even though the taxpayer's actual calculations based on an individual evaluation of the collectability of each of its accounts receivable established that a larger reserve was required.

Each of the issues decided by the Court of Appeals, separately and in conjunction with each other, present important questions concerning the administration of the Internal Revenue Code which should be considered and resolved by this Court, including the extent to which the Commissioner may, at his discretion, reject generally accepted accounting principles. Moreover, this case involves questions as to which there are conflicts among the Courts of Appeals which should be resolved by this Court.

This case presents an issue of crucial financial importance to thousands of manufacturers, wholesalers and retailers who stock large quantities of replacement parts. The Commissioner would require all of them to value these parts at cost until they are scrapped, even though it is clear that substantial portions of these parts will never be sold and have only scrap value. The result is that either taxable income of the manufacturer or dealer is overstated or the parts must be prematurely scrapped to the detriment of the taxpayer and his customers.

OPINIONS BELOW

The opinion of the United States Tax Court, reported at 64 T. C. 154 (1975), is reproduced in the Appendix (A-6). The opinion of the United States Court of Appeals for the Seventh Circuit, reported at 563 F.2d 861 (1977), is reproduced in the Appendix (A-34).

JURISDICTION

The judgment of the Court of Appeals was entered on September 29, 1977 (A-33), and this Petition is filed within 90 days of the entry of that judgment. This Court's jurisdiction is invoked pursuant to 28 U. S. C. § 1254(1).

QUESTIONS PRESENTED

1. Whether the Court of Appeals, in conflict with the principles followed by the Fifth and Sixth Circuits, erred in holding that the Commissioner, at his discretion, could ignore generally accepted accounting principles and determine instead that Petitioner Thor, in calculating its taxable income, could not write down the cost of "excess goods"—primarily replacement parts held in quantities exceeding the number which Thor reasonably determined would be sold and which eventually would be scrapped—to net realizable value (*i.e.*, scrap value), where such writedown:

(a) is in accordance with generally accepted accounting principles, as required by section 446 of the Code, and was so found as a fact by the Tax Court and not questioned by the Court of Appeals;

(b) fulfills the requirement of "best accounting practice" in Thor's trade or business within the meaning of section 471 of the Code, and was so found as a fact by the Tax Court and not questioned by the Court of Appeals;

(c) is not prohibited by the applicable Treasury Regulations but is authorized by a realistic construction of them, and

(d) clearly reflected Thor's income for financial accounting purposes.

2. Whether the Court of Appeals erred in holding, contrary to the Court of Appeals for the First, Sixth and Ninth Circuits, that the Commissioner did not abuse his discretion by requiring that Thor's 1965 addition to its reserve for bad debts be calculated solely on the basis of a mechanical 6-year moving average of Thor's past bad debt experience—an approach that, contrary to the requirements of the Treasury Regulations, ignored the actual currently-existing facts and circumstances affecting the collectability of Thor's accounts receivable at the close of that taxable year.

STATUTORY AND REGULATORY PROVISIONS INVOLVED

Relevant portions of sections 446, 471 and 166 of the Internal Revenue Code of 1954, 26 U. S. C. §§ 446, 471 and 166, and of the Treasury Regulations §§ 1.446-1(a), 1.471-2, 1.471-4, and 1.166-4 are set out in the Appendix (A-1 through A-5).

STATEMENT OF THE CASE

Factual Background.

The relevant facts are uncontroverted and are well-summarized in the Tax Court's Findings of Fact (A-8 through A-17).

Inventory Issue.

In calculating Thor's taxable income for 1964, the Commissioner disallowed $926,952 of Thor's "cost-of-goods-sold," which was the amount of Thor's 1964 writedown of its closing inventory for excess and unsaleable goods.

Thor manufactures hand-held power tools, parts and accessories for commercial and household uses and various commercial rubber products. A typical Thor tool contains from 50 to 200 individual parts, each of which Thor stocks to meet expected customer demand for replacement parts.

It is impossible to accurately predict future demand for each part, so liberal quantities are produced to avoid the need for additional production runs to replenish stock of a part that has been sold out. This would involve uneconomical tooling and set-up costs, which would increase the cost of the part and cause delays in supplying it to customers.

This inventory of replacement parts for a particular tool model is maintained so long as a significant population of the tool model remains in use, which may be for many years after Thor has discontinued producing it. Thor does not scrap such

parts until it is reasonably sure that there will be little or no future customer need.

In 1960, Thor initiated a procedure for reducing the inventory value of replacement parts and accessories for tools which it no longer produced by amortizing their cost over the 10-year period following their discontinuance. For the years 1960 through 1963 such writedowns, totalling $152,117, were not questioned by the Commissioner on audit. During 1964 an additional $22,090 was amortized.

Late in 1964, new management took over Thor and determined that Thor's assets were overvalued. Among other things, management was confronted with realistically valuing more than 44,000 different inventory items at Thor's factories and sales branches, including 33,670 replacement parts and accessories, many of which were held in quantities substantially exceeding any reasonably forseeable demand.

Because of the great number of different items and the relatively low value of each, it was impractical within realistic time limits, to individually estimate how many units of each item would be sold or used to manufacture finished goods. Instead, based on long manufacturing experience and a careful review of the situation, management employed two procedures to ascertain the extent to which inventory exceeded anticipated customer demand and to accurately value such excess stock.

Under the primary procedure, expected demand for each item was forecast on the basis of actual 1964 usage—actual sales for tools, parts and accessories, and actual production for raw materials, work-in-process, and production parts. With this data, the value of the inventory was reduced by a writedown sequence:

(1) that quantity of an item not in excess of 12 months anticipated demand was not written down;

(2) that quantity of an item in excess of 12 months but not in excess of 18 months anticipated demand was written down 50%;

(3) that quantity of an item in excess of 18 months but not in excess of 24 months anticipated demand was written down 75%; and

(4) that quantity of an item in excess of 24 months anticipated demand was written off.

The mechanics of this procedure are well-illustrated by the example from the Tax Court's Findings of Fact (A-11—A-12). As the example shows, actual usage of each item during 1964 was individually applied to estimate how many of each of the 44,000 different items would be sold or used in production. The portion determined to be saleable or useable was carried at full cost (or market value), and the portion deemed excess and unsaleable was written down to its net realizable value (*i.e.*, scrap value). The procedure is self-correcting in that any increase or decrease in sales from one year to the next automatically adjusts the amount of writedown for excess inventory in the latter year.

Although the foregoing procedure was used to determine the value of all excess inventory, supplementary writedowns (in addition to those determined by the primary procedure) were taken at two plants where the 1964 usage data was incomplete. This was done through percentage writedowns of 5, 10 or 50% of specified inventory categories at these locations.

The total writedowns for excess inventory items, primarily parts and accessories, for 1964 were as follows:

10-year amortization of parts for discontinued tools	$ 22,090
Primary writedown formula	744,030
Supplementary writedowns	160,832
	$926,952

Almost all of the excess inventory on hand at the end of 1964, was scrapped between 1965 and 1971.

At trial, Mr. Arthur R. Collins, who became President of Thor in late 1964, testified, without contradiction, that the sole purpose of the inventory valuation procedures was to determine accurate inventory values at the end of 1964, and that their income tax consequences were not considered at all (Tr. 107-108).

In referring to the inventory procedures followed by Thor in 1964, the Tax Court found as facts (A-15) that:

> "Petitioner's closing inventory at December 31, 1964, contained items which, in the opinion of petitioner's management, were unsalable in the normal course of business because they were in excess of reasonably foreseeable demand. *Generally accepted accounting principles required that petitioner reduce the value of its inventory to its net realizable value by eliminating the cost of such excess items.* If petitioner had failed to reflect such a reduction on a reasonable basis, an independent certified public accounting firm auditing its books would have been unable to issue an unqualified opinion certifying that petitioner's financial statements had been prepared in accordance with generally accepted accounting principles. The procedures utilized by petitioner's management to reduce the value of its 1964 closing inventory, *and in particular the procedures it used for eliminating the cost of excess stock,* were consistent with the generally accepted accounting principle of stating inventories at the lower of cost or market, and resulted in petitioner's stating the inventory in issue at its estimate of current net realizable value." (Emphasis added.)

In its opinion, the Tax Court stated (A-19—A-20):

> *"Petitioner produced distinguished members of the accounting profession who testified that the inventory valuation methods employed by petitioner were in accordance with generally accepted accounting principles and thoroughly convinced us that such was the case.* A write-down of inventory for excessive stock in this case was not merely desirable for accounting purposes, it was required in order to produce a certified balance sheet. Petitioner has, therefore, amply demonstrated that *the write-down of inventory*

was in accordance with generally accepted accounting principles and within the term, 'best accounting practice,' as that term is used in section 471 of the Code and the regulations promulgated under that section." (Emphasis added.)

Notwithstanding its own Findings of Fact, the Tax Court determined that Thor's inventory writedown procedures did not clearly reflect its income. Its conclusion seems to rest on two erroneous legal propositions:

(i) that even though a taxpayer's accounting procedures conform to generally accepted accounting principles and constitute "the best accounting practice in the taxpayer's trade or business," the Commissioner has the discretion to prohibit their use, which will be upheld unless it is "plainly arbitrary" and

(ii) that, as a matter of law, excess inventory cannot be written down to net realizable value for Federal income tax purposes because such a write-down is not expressly authorized by the Treasury Regulations.

The Court of Appeals affirmed for reasons similar to those adopted by the Tax Court, adding that the Commissioner did not abuse his discretion in requiring that Thor physically scrap the excess inventory before writing it down.

Bad Debt Issue.

In 1965, Thor added $136,150 to its reserve for bad debts on the basis of an individual analysis of all its accounts receivable. The Commissioner disallowed $74,791 of this amount.

Thor has used, pursuant to § 166 of the Code, the reserve method for calculating its bad debt expense for all pertinent years prior to and after 1965. At the end of 1965, as was done in 1964 and all subsequent years, each of Thor's accounts receivable from unrelated parties in excess of $100 was individually reviewed by credit clerks familiar with that account. If an account was deemed wholly uncollectable, a 100% reserve was established for it. Several accounts totalling $181,391

were determined to be uncollectable. Other overdue accounts were reserved against by 1 or 2%, depending on how long they were overdue. The determinations of the credit clerks were subsequently reviewed by the credit manager, then by Thor's treasurer, and finally by Thor's president.

Notwithstanding these careful procedures, the Commissioner determined that the reserve should be limited to a ceiling calculated by a 6-year average of Thor's past bad debt experience, a procedure which is known as the *Black Motor* formula derived from *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other issues*, 125 F.2d 977 (6th Cir. 1942). The Commissioner gave no reasons to Thor (or to the lower courts) in what way Thor's bad debt evaluation was improper or inaccurate.

At trial, each of the four expert accounting witnesses who testified as to the validity of the *Black Motor* formula, declared that it was deficient in that it ignores present and future factors affecting collectability of accounts receivable (Tr. 217-220; 258-262; 307-308; 336-338).

Despite the Tax Court's Finding of Fact (A-16—A-17) recognizing the careful procedures utilized by Thor in calculating its 1965 addition to its reserve for bad debts, that Court held that the Commissioner had not abused his discretion by limiting the reserve to the 6-year average of Thor's previous bad debt experience, even though this ignored all current data on the collectability of Thor's accounts. Just as the Commissioner has given no reason for substituting this formula, the Tax Court's opinion does not explain how it reached its conclusion.

The Court of Appeals ". . . agree[d] with the Tax Court that the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable." Accordingly, it held that Thor did not establish that the Commissioner had abused his discretion.

REASONS FOR GRANTING THE WRIT.

I.

This Case Presents Important Questions Concerning the Extent to Which the Commissioner May Disregard Provisions of the Code and of the Treasury Regulations That Require Generally Accepted Accounting Principles to Be Followed in Determining Taxable Income—Questions Which Have Resulted in Recurring Litigation and Which Have Produced a Division of Opinion Among the Courts of Appeals.

The decision of the Court of Appeals on the inventory issue is the first, as far as Thor can determine, in which any court has held that the Commissioner has virtually unlimited discretion to set aside inventory procedures used by a taxpayer, in calculating his taxable income, even though they fully conform to generally accepted accounting principles and constitute "the best accounting practice" in the taxpayer's trade or business within the meaning of section 471 of the Code. To this extent, the decision of the Court of Appeals conflicts in principle with the decision of the Court of Appeals for the Fifth Circuit in *Space Controls, Inc.* v. *Comm'r,* 322 F. 2d 144 (5th Cir. 1963), which held that a taxpayer was permitted to write down inventory to its net realizable value because this procedure constituted the best accounting practice. The Fifth Circuit emphasized, *id.* at 149:

> "Considering the sharply defined rule that accounting may be different for business-financial purposes and for tax purposes, the Regulations here accord extraordinary tax significance to financial accounting of inventories."

The same principle was adopted in *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374, 382 (N. D. Ohio 1963), *aff'd on the opinion below,* 351 F.2d 449 (6th Cir. 1965).

A decision by this Court on the inventory issue would resolve a substantial number of cases that are now pending before the United States Tax Court and other Federal courts, and will

forestall the initiation of court action in a much greater number of cases that are now in various stages of administrative review within the I.R.S., all involving the writedown of excess inventory. The *Amicus* Brief being filed by the National Association of Manufacturers in support of this Petition will attempt to identify the extent of this actual and potential litigation.

The reason for this widespread controversy is that in recent years the I.R.S. has, without any change in the applicable Treasury Regulations, commenced to disallow writedowns of excess inventory. Most manufacturers of mechanical and electrical products, including household appliances, television and radio, automobiles and machinery, as well as wholesalers and retailers of them, maintain extensive stocks of replacement parts to service their customers. Because of the inability to predict which parts are going to be troublesome, portions of this inventory are inevitably in excess of what will be sold, and will eventually be scrapped when such parts are no longer needed to serve customers. In short, the discretion of the Commissioner to disregard generally accepted accounting principles in relation to inventory accounting is a recurring question of public importance which should be resolved by this Court. See also the *Amicus* Brief filed by the United States Chamber of Commerce.

The bad debt issue presented in the instant case arises because the Commissioner attempted, as he has done with increasing frequency in other cases, to apply a 6-year average of bad debt experience—commonly known as the *Black Motor* formula[1]—as a limit of the amount of Thor's bad debt reserves. This approach has resulted in at least 41 reported cases before the Tax Court and other Federal courts.[2] Contrary to the decision of the Court of Appeals in this case, the Courts of Appeals for the First, Sixth and Ninth Circuits have refused to permit the

1. *Black Motor Co.,* 41 B. T. A. 300 (1940), *aff'd on other grounds,* 125 F. 2d 977 (6th Cir. 1942), *acq.* 1944 C. B. 3.

2. See generally Whitman, Gilbert & Picotte, *The Black Motor Bad Debt Formula: Why It Doesn't Work and How to Adjust It,* 35 J. of Taxation 366 (1971).

Commissioner to use arbitrary calculations to the exclusion of relevant current data on collectability. See *Calavo, Inc.* v. *Comm'r,* 304 F.2d 650 (9th Cir. 1962); *Travis* v. *Comm'r,* 406 F.2d 987 (6th Cir. 1969); and *Rhode Island Hospital Trust Co.* v. *Comm'r,* 29 F. 2d 339 (1st Cir. 1928), *rev'g* 8 B. T. A. 555 (1927). See also *Atlantic Discount Co.* v. *United States,* 473 F. 2d 412 (5th Cir. 1973), which is arguably consistent with the decision of the Seventh Circuit in the instant case.

Furthermore, the Commissioner's determination on the bad debt issue is in square conflict with Treasury Regulation § 1.166-4(b)(1).

The fact that the Court of Appeals sustained the action of the Commissioner on *both* the inventory and bad debt issues not only produces incongruous results, but also highlights the necessity for this Court to provide guidance concerning the extent to which the Commissioner may exercise his discretion in rejecting generally accepted accounting principles. In valuing its excess inventory, Thor primarily utilized a formula directly based on historical data to value 44,000 different items of inventory which practically could not be valued on an item-by-item basis. Notwithstanding the fact that this procedure was in accordance with generally accepted accounting principles, the Court of Appeals held that the Commissioner did not abuse his discretion in determining that such method did not clearly reflect Thor's income. Conversely, although Thor evaluated its accounts receivable on an item-by-item basis, the Court of Appeals held that the Commissioner did not abuse his discretion by requiring Thor to value these accounts on the basis of an historical formula.

In effect, the Court of Appeals afforded the Commissioner virtually unlimited discretion to disregard generally accepted accounting principles with respect to both aspects of the valuation process that are at issue in this case. However, when it enacted sections 446, 471 and 166(c) of the Code, Congress did not intend the Commissioner to have such broad authority, independent of any objective standards, applied inconsistently,

to impose his own view of "proper" accounting on taxpayers whose accounting procedures unequivocally comply with generally accepted accounting principles, are the best accounting practice in their trade or business, and are consistent with the applicable Treasury Regulations.

II.

The Court of Appeals Erroneously Held That Thor Was Not Permitted, in Accordance with Generally Accepted Accounting Principles, to Write Down the Excess and Unsaleable Goods in Its Inventory from Cost to Net Realizable Value Where This Commonly-Used Accounting Procedure Is Authorized by the Code, Permissible Under Treasury Regulations, and Clearly Reflects Thor's Taxable Income.

A. Thor's Writedowns of Excess Inventory to Net Realizable Value, Which Are in Conformity with Generally Accepted Accounting Principles and Constitute the Best Accounting Practice, Are Presumed by Sections 446 and 471 of the Code and by the Treasury Regulations Thereunder to Clearly Reflect Thor's Taxable Income.

As the Findings of Fact of the Tax Court show, Thor established, through its independent accountants and expert witnesses, representing four of the "Big 8" international accounting firms,[3]

3. The importance of this case is attested to by the preeminent practicing accountants who testified on behalf of Thor. These included:

The late Robert M. Trueblood, C. P. A. since 1937, and at the time of trial the Chairman of the Board of Touche Ross & Co.; past president of the American Institute of Certified Public Accountants ("AICPA"), then Chairman of the AICPA 9-member Commission on the Objectives of Accounting; former member of both of the AICPA Long-Range Objectives Committee and of the prestigous Accounting Principles Board, which for many years was the accounting profession's primary authority on matters of accounting principles and practice. (Tr. 177-180.)

Newman T. Halvorson, C. P. A. since 1930, and at the time of trial the national partner-in-charge of Technical Auditing

(Footnote continued on next page.)

that generally accepted accounting principles required it to write down its excess inventory to net realizable value; that its procedures for doing so conformed to generally accepted accounting principles and constituted the best accounting practice in its trade or business; that the result of these writedowns was to clearly state its financial accounting income; and that, had Thor refused to write down its inventory in 1964, its independent auditors would not have been able to render an unqualified opinion ("certified") concerning its profit and loss statement and balance sheet.

Under these factual circumstances, the Code and the Regulations create a presumption that a taxpayer's taxable income is the same as its financial income.

Section 446 of the Code states in mandatory language that:

> "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books."

(Footnote continued from preceding page.)

and Accounting Services for Ernst & Ernst; member of the AICPA Accounting Principles Board. (Tr. 283-286.)

Bertrand J. Belda, C. P. A. since 1931, and at the time of trial the national partner-in-charge of Management Consulting Services for Ernst & Ernst, specializing in management accounting, including matters of inventory valuation. He participated in drafting the comments which the Division of Federal Taxation of the AICPA submitted in 1972 to the Treasury Department, at the Treasury's request, on the proposed revisions of the Regulations governing the valuation of inventories, discussed at p. 23 *infra*. (Tr. 263-270.)

Frank T. Weston, C. P. A. since 1939, at the time of trial Chairman of the Committee of Accounting and Auditing Standards of Arthur Young & Co.; a member of AICPA Accounting Principles Board and of the 9-member Commission on the Objectives of Accounting. (Tr. 340-343.)

Howard B. Burris, C. P. A. since 1950, and at the time of trial a partner of S. D. Leidesdorf & Co., a member of the Committees on Auditing Procedure and on Accounting Principles of that firm; and a member of the AICPA Committee on Auditing Procedure. (Tr. 315-316.)

Section 446(b) permits the Commissioner to require a different method of accounting by the taxpayer only if the taxpayer's method "does not clearly reflect income". Otherwise, the taxpayer's accounting method, including subordinate practices such as Thor's excess inventory writedown procedures, is controlling for tax accounting purposes. See Treas. Reg. § 1.446-1(a)(1).

Treasury Regulation § 1.446-1(a)(2) elaborates upon the statute:

> "A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will *ordinarily be regarded as clearly reflecting income. . . .*" (Emphasis added.)

Section 471 of the Code, governing inventory accounting, provides:

> "Whenever . . . the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

This language imposed dual requirements for inventory accounting *on both the taxpayer and the Commissioner*: (i) it must conform to the "best accounting practice in the trade or business" of the taxpayer, and (ii) it must clearly reflect income.

After discussing these two criteria, Treasury Regulation § 1.471-2(b), in effect for the year at issue, states:

> "It follows, therefore, that inventory rules *cannot be uniform* but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. . . . *An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a*

general rule, be regarded as clearly reflecting his income." (Emphasis added.)

The Tax Court found as a fact that Thor's method of accounting for valuing excess inventory both conformed to generally accepted accounting principles and was the "best accounting practice" in its trade or business. That finding, as a matter of law, created a presumption that Thor's procedures clearly reflected its income. Inasmuch as the Commissioner introduced no evidence on this point, the presumption should establish that Thor's income was clearly stated. This should conclude the matter.

The Court of Appeals nullifies this presumption by declaring that the Commissioner is free to determine whether the best accounting practice clearly reflects taxable income. The opinion is devoid of any standard by which the Commissioner is to make his determination. In fact, once he has acted, "the taxpayer must show that the Commissioner's act was 'plainly arbitrary'" (A-40).

This surprising position is apparently founded on two concepts:

(i) that financial accounting is not oriented to the annual accounting concepts required for income tax accounting (A-40); and

(ii) that the case law gives the Commissioner discretion, subject only to not being plainly arbitrary, to set aside a taxpayer's accounting procedures, regardless of whether they conform to generally accepted accounting principles or constitute the best accounting practice (A-40).

1.

The Court bases its conclusion that tax accounting is not directed to the annual period upon the specialized prepaid income cases, *Schlude* v. *Comm'r*, 372 U. S. 128 (1963), and *American Automobile Association* v. *United States*, 367 U. S. 687 (1961),

and upon a 1930 case in which the taxpayer compiled its inventories according to the "base stock method," which is designed to switch income between years and therefore is improper under both generally accepted accounting principles and tax accounting, *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264 (1930). Although the prepaid income cases are thought to depart from generally accepted accounting principles, their outcome was substantially influenced by this Court's interpretation of the legislative intent. 367 U. S. at 694-698. Moreover, as has been shown above, section 471 makes tax accounting for inventories specially dependent on generally accepted accounting principles; except for the general strictures of section 446, there is no comparable provision in the Code for prepaid income.

It is far more helpful to look at authoritative accounting sources as to how important the annual period is to financial accounting for inventories.

The American Institute of Certified Public Accountants' ("A. I. C. P. A.") Accounting Principles Board Statement No. 4, entitled "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," declares in chapter 2:

> "Changes in Financial Position—the Income Statement. The income statement for a period . . . presents an indication in conformity with generally accepted accounting principles of the results of the enterprise's profit-directed activities during the period. The information presented in an income statement is *usually considered the most important information provided by financial accounting* because profitability is a paramount concern to those interested in the economic activities of the enterprise." (Emphasis added.)

Accounting Research Bulletin No. 43, Ch. 4, applies this to inventory accounting.[4]

4. Relevant portions of ARB 43 are Exhibit 28 of the record in this case. The binding nature of formal opinions issued by the Accounting Principles Board is set out in the introductory material

(Footnote continued on next page.)

Statement 4 of that chapter of ARB 43 specifies:

> ". . . the major objective in selecting [an inventory] method should be to choose the one which, under the circumstances, *most clearly reflects periodic income.*" (Emphasis added.)

Statement 5 provides:

> "A departure from the cost basis of pricing the inventory is *required* when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the *current period.* This is generally accomplished by stating such goods at a lower level commonly designated as *market.*" (Emphasis added.)

In applying Statement 5, Statement 6 sets forth the limit of the "market" value to net realizable value:

> "As used in the phrase *lower of cost or market* the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> "(1) Market should not exceed the net realizable value (*i.e.,* estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal). . . ."

The expert accounting witnesses testified without contradiction that Statements 5 and 6 represent the relevant generally accepted accounting principles.

2.

The case law does not support the unqualified assertion of the Court of Appeals that the Commissioner's determination—that

(Footnote continued from preceding page.)
to ARB 43, and is recognized by the profession. This includes specifically ARB 43, which, as one of the expert witnesses testified, the accounting profession regards as the "bible"—the controlling statement of what constitutes "generally accepted accounting principles." (Tr. 183-185).

a taxpayer's inventory procedures do not clearly reflect income—will not be set aside unless the taxpayer can show that it is plainly arbitrary. None of the cases cited by the Court of Appeals (or the Tax Court) for this proposition involved situations where the taxpayer's accounting procedures were in conformity with generally accepted accounting principles or constituted the best accounting practice. Two of those cases involved attempts by taxpayers to defer commission income,[5] and the others involved inventory procedures which were not in conformity with generally accepted accounting principles.[6]

On the contrary, in the only cases involving inventory procedures which conformed to generally accepted accounting principles, the courts, unlike the Court of Appeals in the present case, refused to allow the Commissioner to substitute his own "preferred" procedure. In *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N. D. Ohio 1963), in which the Court of Appeals expressly adopted the District Court's opinion, 351 F. 2d 449 (6th Cir. 1965), the District Court permitted a taxpayer to write down to net realizable value partially completed presses being built to the customer's specifications on the fixed contract. The Court stated, 224 F. Supp. at 382:

> "An evaluation of the evidence outlined above leaves no room for doubt that plaintiff's method of valuing its work in process inventory is in harmony with generally accepted

5. *Brown* v. *Helvering,* 291 U. S. 193 (1934) (reserve against commission income); *Comm'r* v. *Hansen,* 360 U. S. 446 (1959) (deferral of commission on customer notes discounted by automobile dealers with finance companies).

6. *Lucas* v. *Kansas City Structural Steel Co.,* 281 U. S. 264 (1930) ("base stock" inventory method is improper); *Bangor Punta Operations, Inc.* v. *United States,* 466 F. 2d 930 (7th Cir. 1972); ("practical capacity method" for allocating manufacturing overhead to inventory is improper); *Photo-Sonics, Inc.,* 42 T. C. 926 (1964), *aff'd,* 357 F. 2d 656 (9th Cir. 1966) ("prime cost method" for allocating manufacturing overhead to inventory is improper); *All-Steel Equipment Inc.,* 54 T. C. 1749 (1970), *aff'd,* 467 F. 2d 1184 (7th Cir. 1972) ("prime cost method" for allocating manufacturing overhead to inventory is improper).

accounting principles. . . . These conclusions are compelled by . . . the testimony of the taxpayer's witnesses, all of whom are certified public accountants of wide and extensive experience in auditing accounts of large publicly owned corporations. . . .

"It was established also that an inventory valued in accordance with generally accepted accounting principles may be considered as one that conforms 'as nearly as may be to the best accounting practice in the trade or business.' "

The Court explicitly approved the proposition that the limit of "market" value is net realizable value as defined in Statement 6 of Accounting Research Bulletin 43, Ch. 4, quoted at page 18 above. *Id.* at 379. In reaching this result, the Court observed that ". . . there can be no open market for a partially finished press built to specifications of a particular purchaser . . ." so that the taxpayer was entitled to " 'use such evidence of fair market price at the date or dates nearest the inventory as may be available'." *Id.*, at 379. This reasoning equally applies to excess replacement parts.

Similarly, the Fifth Circuit Court of Appeals held in *Space Controls, Inc.* v. *Comm'r,* 322 F. 2d 144 (5th Cir. 1963), that a taxpayer incurring a loss in manufacturing military trailers under a fixed price contract was entitled to write down its closing inventory to net realizable value. The Court specifically rejected the Commissioner's arguments, *almost identical to the ones made by him in this case,* that no writedown was permitted because all of the conditions of the Regulations were not fulfilled, the goods were not damaged or imperfect, the net realizable value was less than replacement cost, and the loss had not been realized because the goods had not yet been delivered. In reaching its conclusion, the Court stressed the importance that section 471 of the Code and Treasury Regulation § 1.471-2 attribute to financial accounting rules for inventory, *id.* at 149:

"Considering the sharply defined rule that accounting may be different for business-financial purposes and for tax purposes, the Regulations here accord extraordinary tax significance to financial accounting of inventories."

Even under the Court of Appeals' "clearly arbitrary" standard, the Court erred in sustaining the action of the Commissioner in the instant case. The Commissioner would require Thor to value its inventory at the end of 1964 at $927,000 greater than its net realizable value. Nowhere does the Commissioner contend or the lower courts' opinions suggest that Thor's procedures undervalued this inventory. The Commissioner's overvaluation would increase Thor's cost-of-goods-sold by the same amount and in turn equally overstate its taxable income. It is hard to see how such a large overvaluation, which continues year after year, is not arbitrary.

B. Thor's Inventory Valuation Procedures Are Not Prohibited by the Treasury Regulations, But Are Authorized by a Realistic Construction of Them.

In attempting to determine whether Thor's procedures clearly reflected its taxable income, the Court of Appeals analyzes both the specific and the general provisions of the Regulations, on the premise that unless the Regulations authorize a particular procedure, the Commissioner has complete discretion to set aside that procedure as not clearly reflecting income (A-41).

This premise determines the outcome, because the Commissioner, Thor and both of the lower courts agree that the Regulations do not explicitly cover the problem of excess goods. But more importantly, the premise raises the Regulations to the status of an enabling statute, plainly contrary to the rule established by this Court in such cases as *Manhattan General Equipment Co.* v. *Comm'r,* 297 U. S. 129, 134-35 (1936):

"The power of an administrative officer or board to administer a federal statute and to prescribe rules and regulations to that end is not the power to make law—for no such power can be delegated by Congress—but the

power to adopt regulations to carry into effect the will of Congress as expressed by the statute."

The Court of Appeals' opinion cites no cases or other authority supporting its premise that silence or ambiguity of the Regulations constitutes a prohibition, nor has Thor been able to find any. On the contrary, the cases establish that Thor's inventory writedown procedure is proper so long as it is *not inconsistent* with the Regulations. See *Fort Howard Paper Co.*, 49 T. C. 275 (1967), distinguishing *Photo-Sonics, Inc.*, 42 T. C. 926 (1964), *aff'd*, 357 F.2d 656 (9th Cir. 1966). The Tax Court itself has forcefully rejected the Commissioner's argument that an inventory method had to be authorized by the Regulations. In *Hutzler Brothers Co.*, 8 T. C. 14, 28 (1947), it said:

> "All of the regulations are as consistent with petitioner's position as they are with that of respondent. . . . It is simpler and more rewarding to seek the meaning of the statute itself than of ambiguous and largely irrelevant administrative interpretations."

The idea that the Regulations must authorize writedowns of excess merchandise is particularly troublesome in light of the established doctrine that taxpayers are entitled to reduce gross income by the cost-of-goods-sold as a constitutional right under the Sixteenth Amendment. *Lela Sullenger*, 11 T. C. 1076, 1077, *app. dis.* (5th Cir. 1950), *nonacq.* 1949-1 C. B. 6, *acq.* 1952-2 C. B. 3, *nonacq.* 1976-1 C. B. 1; *cf. Burnet* v. *Logan*, 283 U. S. 404 (1931); *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179 (1918); *Comm'r* v. *Weisman*, 197 F. 2d 221 (1st Cir. 1952). Accordingly, a taxpayer's right to deduct cost-of-goods-sold does not depend on legislation, thereby making inapplicable the rule of *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 440 (1934), that *deductions* from gross income are a matter of legislative grace. *A fortiori*, the taxpayer's right to have his inventory accurately valued for cost-of-goods-sold purposes does not depend on regulatory grace.

It is inherently unfair for the silence or ambiguity of the Treasury Regulations to operate against the taxpayer when the Treasury has been aware, at least since the early 60's, that the Regulations do not cover the problem of valuing excess inventory. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, 23 N. Y. U. Institute on Federal Taxation, 839, 850 (1965). Indeed, in 1972, at its own request, the Treasury received from the A. I. C. P. A.'s Division of Federal Taxation a statement on proposed amendments to the inventory Regulations under § 471, which strongly declared that one of the shortcomings of the Regulations was its failure to explicitly cover excess inventory.

Even though Thor is entitled to write down its excess inventory to net realizable value regardless whether the Regulations expressly authorize it, the fact is that two provisions of the Regulations, properly construed, would authorize the writedown. Neither explicitly covers excess inventory, but both embody the generally accepted accounting principles set forth at pp. 14-16 above.

Treasury Regulation § 1.471-4(b) provides for a writedown of normal goods to net realizable value where market conditions are not normal:

> "Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory *as may be available*, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith. . . ."

Market conditions are not normal for excess quantities of replacement parts which are of value only to someone needing that part.

Also consistent with generally accepted accounting principles, § 1.471-2(c) specifically permits taxpayers to write down the value of subnormal goods in inventory to net realizable value without having to scrap the merchandise.

"... Any goods in an inventory which *are unsalable at normal prices or unusable in the normal way* because of damage, imperfections, shop wear, changes of style, odd or broken lots, or *other similar causes* ... should be valued at *bona fide* selling prices less direct cost of disposition. . . ." (Emphasis added.)

Although the Court of Appeals concluded that the term "other similar causes" used in the Regulation does not apply to excess goods because they are "not distinguishable from other units of inventory", it did not explain the relevance of such a requirement, nor do the cases cited by it support it (A-42).

The Court's opinion would also require Thor to offer replacement parts at lower prices within 30 days of the year-end valuation date in order to write them down. This literal application of § 1.471-2(c) is wholly impractical and has been rejected for obsolete goods. *Queen City Woodworks & Lumber Company* v. *Crooks,* 7 F. Supp. 684, 685 (S. D. Mo. 1934).

The very nature of excess stock precludes literal application of the 30-day rule. Excess stock exists, by definition, where a portion of the supply of an item in inventory is saleable at normal prices, while remaining quantities of that item cannot be sold at any price (except as scrap). To apply the 30-day rule, the taxpayer would have to offer to give away the excess quantities, while attempting to merchandise the saleable portion at normal prices. This perforce would destroy the market for the saleable quantities. As Thor's president testified, service parts are useful only to replace damaged or worn out parts in tools previously sold, so price changes for parts have little or no effect on demand. (Tr. 108.)

C. Because Thor's Writedown of Excess Inventory Clearly Reflected Thor's Financial Accounting Income, It Clearly Reflected Its Taxable Income.

As a final reason justifying the Commissioner's determination that Thor's method did not clearly reflect its income, the Court

of Appeals states (A-46) that Thor's accounting experts ". . . did not testify that its 1964 income had been clearly reflected in its tax returns. . . ." This is true—because they were not qualified tax experts—but irrelevant. They did testify unequivocally and without contradiction that Thor's writedowns were required to correctly state its financial income. It follows—pursuant to the presumption created by the Code and Regulations in favor of the taxpayer's accounting method if it conforms to generally accepted accounting principles and is the best accounting practice—that Thor's taxable income was also correctly stated.[7]

D. Requiring Excess Inventory to Be Carried at Original Cost Until It Is Scrapped Is Contrary to the Provisions of Sections 446 and 471 of the Code.

The Court of Appeals concludes its discussion by stating that the Commissioner was entitled, in his discretion, to require losses on excess inventory to be realized by scrapping rather than permit writedowns to net realizable value when the taxpayer's inventory valuation procedures determined that such inventory was in excess of foreseeable customer demand and was therefore unsaleable.

The cases cited by the court do not support its conclusion.[8] On the contrary, it conflicts with the only case closely on point.

7. The Court of Appeals has raised the issue (A-45) whether all of the excess inventory arose during 1964 or whether some of it arose in earlier years. The Tax Court, by its pretrial order, ruled that evidence on this issue would not be introduced at the initial trial. Thus, the year or years in which the excess arose can be determined by remand. The years 1961 through 1963 are not barred by the statute of limitations.

8. *Brown* v. *Helvering,* 291 U. S. 193 (1934) (reserve against commission income for contingent cancellations of insurance policies); *United States* v. *American Can Co.,* 280 U. S. 412 (1930) (*write-up* of inventory from cost to a higher market value by the taxpayer); *Lucas* v. *American Code Co.,* 280 U. S. 445 (1930) (reserve for contingent commission liability which was the subject of litigation); *American Can Co.* v. *Bowers,* 35 F. 2d 832 (2nd Cir. 1929), *cert. denied,* 281 U. S. 736 (1930) (same issue as in *United States* v. *American Can Co., supra*).

In *C-O-Two Fire Equipment Co.* v. *Comm'r*, 219 F. 2d 57, 59 (3rd Cir. 1955), the Third Circuit Court of Appeals rejected the Commissioner's argument that obsolete goods could not be written down until they were scrapped.

To require scrapping is wholly inconsistent with sections 446 and 471 of the Code, which base tax accounting on the taxpayer's financial accounting methods provided they conform to generally accepted accounting principles and constitute the best accounting practice. Generally accepted accounting principles prohibit delaying writedowns of excess goods until they are scrapped, because this has the effect of overstating the current year's income and understating the income of the year in which the goods are scrapped. From the viewpoint of the revenues, the scrapping test creates a much greater opportunity for a taxpayer to manipulate income by carrying worthless excess inventory at cost, and then scrapping it in a year where it will create a maximum income tax benefit.

The effect of the Court's decision conflicts with the growing awareness that society must conserve its resources. Efficiencies of production dictate that replacement parts be produced in sufficient quantities to avoid costly tooling and set-up charges for reruns. Adequate quantities of spare parts directly benefit the consumers by making spare parts more readily available and less expensive. This permits the customer to keep a tool in use rather than have to uneconomically replace it because one small part of it has broken. Such a sound policy, which is customary among thousands of manufacturers, inevitably will result in the production of excess quantities of some replacement parts.

By insisting that these excess quantities cannot be reduced to their net realizable value until they are actually scrapped, the Commissioner is presenting the taxpayer with an unrealistic and uneconomical choice: either overvalue your inventory and pay too much tax or scrap the excess parts to the detriment of your customers—and to society generally.

III.

The Court of Appeals, in Conflict with Decisions of Other Courts of Appeals, Erroneously Held That Section 166(c) of the Code Gives the Commissioner the Discretion to Mechanically Limit a Taxpayer's Reserve for Bad Debts to a Six-Year Average of Its Bad Debt Experience to the Exclusion of Any Current Facts Concerning the Collectability of Its Accounts.

It is undisputed, as the Court of Appeals acknowledged, that at the close of 1965 the collectability of all of Thor's accounts receivable was estimated by the Thor personnel most familiar with each account and their estimates were reviewed by three levels of management (A-47). These careful, detailed computations resulted in a total addition to Thor's bad debt reserve of $135,150. In spite of Thor's exacting computations, the Commissioner recomputed what he considered to be a "reasonable addition" to the reserve by applying the six-year average, or *Black Motor* formula, to the 1965 accounts receivable.[9] The Commissioner divided the total of accounts written off by Thor during the tax year in question and the five preceding years by the total of year-end receivables for all six years. The resulting percentage was then applied to the 1965 year-end receivables, and the $74,790.80 by which Thor's claimed deduction exceeded the product of this calculation was disallowed.

The Commissioner's mechanical application of the *Black Motor* formula is inconsistent with the mandates of section 166(c) of the Code, with the applicable Treasury Regulations, and with the decisions of other Courts of Appeals that have considered the same or similar issues. Indeed, application of the *Black Motor* formula in the instant situation is contrary to the *Black Motor* case itself where the Board of Tax Appeals held that all of the facts and circumstances had to be considered

9. This procedure is derived from *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other grounds*, 125 F. 2d 977 (6th Cir. 1942), *acq.* 1944 C. B. 3.

in determining what constituted a "reasonable addition" to bad debt reserves and that the use of a mechanical formula for this purpose was only permissible when facts necessary to determine a "reasonable addition" to bad debt reserves were unavailable.[10]

Section 166(c) of the Code provides that, in lieu of charging specific bad debts against its income, a taxpayer such as Thor which has properly elected the reserve method ". . . shall be allowed (in the *discretion* of the Secretary or his delegate) a deduction for a *reasonable* addition to a reserve for bad debts." (Emphasis added.) The statute sets forth two distinct requirements: (i) an exercise of discretion by the Commissioner in order to arrive at (ii) a reasonable addition to the reserve. Treasury Regulation § 1.166-4(b)(1) states that what is reasonable ". . . shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition."[11]

Notwithstanding the statutory mandate that the Commissioner exercise his discretion in determining additions to bad debt reserves, he did not do so, and the Court of Appeals in turn abdicated its responsibility for determining whether the Commissioner had properly exercised or had abused his discretion. In characterizing its role, that Court held "As we have stated before, the issue thus presented 'is whether the Commissioner's view is reasonable.' [Citations omitted.] If it is, the inquiry is ended" (A-48). Since use of a historical average is not *per se* reasonable or unreasonable, but becomes so only when viewed in the context of particular facts, the Court of Appeals (and the Tax Court) abandoned its review function and deferred entirely to the use of the *Black Motor* formula by the Commissioner.

10. The opinion in *Black Motor*, 41 B. T. A. at 304, states:

> "The test, however, is whether the amount ultimately determined, regardless of formula, constitutes a reasonable addition to petitioner's reserve. What constitutes a reasonable addition will depend upon the facts and circumstances of the business engaged in with relation to general business conditions. A method or formula that produces a reasonable addition to a bad debt reserve in one year, or a series of years, may be entirely out of tune with the circumstances of the year involved."

11. Indeed, in Rev. Rul. 76-362, 1976-2 C. B. 45, the Commissioner himself recognized that the *Black Motor* formula is not *per se* reasonable:

> ". . . [I]f the taxpayer can demonstrate that an amount greater than the amount determined under the *Black Motor* formula is reasonable, in light of the facts existing at the close of the taxable year, the taxpayer may compute the greater amount to be added to the reserve for bad debts."

This Revenue Ruling refers to the Tax Court decision in *Westchester Development Co.*, 63 T. C. 198 (1974), *acq.* 1975-2 C. B. 2, which found that a mechanical application of the *Black Motor* formula was an abuse of discretion by the Commissioner.

Other Courts of Appeals have for good reason been unwilling to permit the Commissioner to apply the *Black Motor* formula at will, requiring instead a showing that the statutory mandate of exercising discretion be followed. In *Calavo, Inc.* v. *Comm'r*, 304 F. 2d 650 (9th Cir. 1962), the Ninth Circuit correctly held that application of the *Black Motor* formula without regard to the uncollectability of a specific account was inconsistent with section 166(c). In its remand, that Court directed the Tax Court to resubmit the question to the Commissioner ". . . for an exercise of his discretion free from his erroneous conception that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to [the] reserve." *Id.* at 655.[12]

Rhode Island Hospital Trust Co. v. *Comm'r*, 29 F. 2d 339 (1st Cir. 1928), *rev'g* 8 B. T. A. 555 (1927), was decided prior to *Black Motor*, but it involved a similar failure by the Commissioner to exercise his discretion. The Commissioner disallowed a bad debt deduction of $87,500 and refused to permit

12. The Ninth Circuit later qualified *Calavo* in *United States* v. *Haskel Engineering & Supply Co.*, 380 F. 2d 786 (9th Cir. 1967), *rev'g* 17 Am. Fed. Tax R. 2d 861, 66-1 U. S. Tax Cas. ¶ 9257 (S. D. Cal. 1966), apparently on the ground that the Commissioner had reviewed the factors urged by the taxpayer and properly elected to ignore them. The taxpayer in *Haskel* apparently did not determine that any of its receivables were wholly uncollectable.

the addition of any portion thereof to the taxpayer's reserve for bad debts. The Court of Appeals remanded the case for a determination, in light of the particular facts, of the amount which should be added to the taxpayer's reserve, observing ". . . if the Commissioner and the Board of Tax Appeals exercised their discretion, on legal and reasonable grounds, this court could not substitute its discretionary judgment for that of the tax authorities. But if there was [a] failure really to exercise discretion, or error of law in its exercise, then the court must grant relief." 29 F. 2d at 341.

See also *Travis* v. *Comm'r,* 406 F. 2d 987 (6th Cir. 1969), in which the Commissioner's refusal to permit an addition to a bad reserve equal to price decreases arising from the renegotiation of dance studio contracts constituted a failure to take into account actual facts concerning collectability of amounts due under the contracts. The Court of Appeals held that this failure to take into account facts relating to collectability rendered the calculation of the reserve by the Commissioner "unrealistic and 'clearly erroneous.'" *Id.* at 991.

The conflict between the Courts of Appeals thus raises the issue of whether the Commissioner is to be allowed unfettered discretion to apply the *Black Motor* formula, or other similar mechanical approach, as a ceiling upon a taxpayer's bad debt reserve, or whether, as is true in the First, Sixth and Ninth Circuits, he must consider the actual facts in an attempt to arrive at a reasonable result.[14] Thus, mechanical application of the *Black Motor* formula, adopted by the Court of Appeals in the instant case, is not only inconsistent with the decisions of

14. The approach of the First, Sixth and Ninth Circuits has been followed in various other cases, including *Norfolk Industrial Loan Ass'n* v. *United States,* 26 Am. Fed. Tax R. 2d 70-5296, 70-5304, 1970-2 U. S. Tax Cas. ¶ 9527 (E. D. Va. 1970); *Richardson* v. *United States,* 330 F. Supp. 102 (S. D. Tex. 1971); *Gold-Pak Meat Co.,* 30 T. C. M. (CCH) 337, 1971 T. C. M. (P-H) ¶ 71,083 (1971); and *Duffey* v. *Lethert,* 11 Am. Fed. Tax R. 2d 1317, 63-1 U. S. Tax Cas. 88,182 (D. Minn. 1963).

other Courts of Appeals but is also inconsistent with section 166(c) of the Code, with Treas. Reg. § 1.166-4(b)(1), and, indeed, with the *Black Motor* case itself.

CONCLUSION

For all of the foregoing reasons, Petitioner respectfully requests that a Writ of Certiorari issue to review the judgment of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner, Thor Power Tool Co.

Of Counsel:
MAYER, BROWN & PLATT.

APPENDIX

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The pertinent sections of the Internal Revenue Code and the related Treasury Regulations for the period in question are:

Section 446, 26 U. S. C. § 446, provided in part:

> "General Rule for Methods of Accounting.
>
> "(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.
>
> "(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.
>
> "* * *"

Treas. Reg. § 1.446-1 (T. D. 6282, filed 12/24/57; republished in T. D. 6500, filed 11/25/60; amended by T. D. 6584, filed 12/20/61) provided in part:

> "General Rule for Methods of Accounting.
>
> "(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term 'method of accounting' includes not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item. . . . Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. . . .

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

"* * *"

Section 471, 26 U. S. C. § 471, provided:

"General Rule for Inventories.

"Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Treas. Reg. § 1.471-2 (T. D. 6336, filed 12/1/58; republished in T. D. 6500, filed 11/25/60) provided in part:

"Valuation of Inventories.

"(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

"(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be

given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§ 1.471-1 through 1.471-9. An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

"(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market whichever is lower. . . . Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including secondhand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

"* * *"

Treas. Reg. § 1.471-4 (T. D. 6336, filed 12/1/58; republished in T. D. 6500, filed 11/25/60) provided in part:

"Inventories at Cost or Market, Whichever is Lower.

"(a) Under ordinary circumstances and for normal goods in an inventory, 'market' means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand. . . .

"(b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

"* * *"

Section 166, 26 U. S. C. § 166, provided in part:

"Bad Debts.

* * *

"(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a) [permitting the deduction for any debt which becomes wholly worthless within the taxable year], there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

"* * *"

Treas. Reg. § 1.166-4 (T. D. 6403, filed 7/30/59; republished in T. D. 6500, filed 11/25/60; amended by T. D. 6728, filed 5/4/64) provided in part:

"Reserve for Bad Debts.

"(a) *Allowances of deduction.* A taxpayer who has established the reserve method of treating bad debts and

has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

"(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

"* * *"

64 UNITED STATES TAX COURT REPORTS

THOR POWER TOOL COMPANY, PETITIONER v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 4795-69. Filed May 6, 1975.

Where the petitioner valued its inventory at the lower of cost or market, the Commissioner did not abuse the discretion vested in him under sec. 471, I.R.C. 1954, by reducing the petitioner's cost of goods sold and restoring to income the amount by which the petitioner reduced the value of its 1964 closing inventory to reflect the current net realizable value rather than current replacement cost of units of inventory determined to be excess under procedures in accordance with generally accepted accounting principles.

In computing petitioner's cost of goods sold for the taxable year 1964, the Commissioner did not abuse the discretion vested in him under sec. 471, I.R.C. 1954, by disallowing an addition of $22,090 in the taxable year 1964 to a reserve for inventory valuation account (which addition decreased ending inventory and increased cost of goods sold) to provide for reduction in the value of inventory of replacement parts and accessories stocked for tools no longer manufactured by petitioner.

The Commissioner did not abuse the discretion vested in him under sec. 166(c) by disallowing a portion of petitioner's addition to its reserve for bad debts for the taxable year 1965.

Mark H. Berens, Lee N. Abrams, and *John E. Allen,* for the petitioner.

Seymour I. Sherman, for the respondent.

GOFFE, *Judge*: The Commissioner determined deficiencies in petitioner's Federal income tax as follows:

Taxable year	*Deficiency*
1963	$545,997.64
1965	59,701.35

The deficiency for the taxable year 1963 results primarily from a disallowance in full of a net operating loss deduction carried back from the taxable year 1964. Adjustments to the taxable year 1964 are, therefore, involved herein. Certain adjustments in the statutory notice of deficiency have been resolved by the parties leaving the following issues for decision:

(1) Where the petitioner valued its inventory at the lower of cost or market, did the Commissioner abuse the discretion vested in him under section 471,[1] I.R.C. 1954, by reducing the petitioner's cost of goods sold and restoring to income the amount by which the petitioner reduced the value of its 1964 closing inventory to reflect the current net realizable value[2] rather than current replacement cost of units of inventory determined to be excess under procedures in accordance with generally accepted accounting principles?

(2) In computing petitioner's cost of goods sold for the taxable year 1964, did the Commissioner abuse the discretion vested in him under section 471, I.R.C. 1954, by disallowing an addition of $22,090 in the taxable year 1964 to a reserve for inventory valuation account (which addition decreased ending inventory and increased cost of goods sold) to provide for reduction in the value of inventory replacement parts and accessories stocked for tools no longer manufactured by petitioner?

(3) Did the Commissioner abuse the discretion vested in him under section 166(c), I.R.C. 1954, by disallowing a portion

1. Unless otherwise noted, all Code section references are to the Internal Revenue Code of 1954 in effect during the taxable years in issue.

2. "Net realizable value" consists of the estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal. Accounting Research Bull. No. 43, p. 31 (1961).

of petitioner's addition to its reserve for bad debts for the taxable year 1965?

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and attached exhibits are incorporated by reference.

Petitioner Thor Power Tool Co. is a corporation organized under the laws of the State of Delaware. At the time the petition was filed and during the years in controversy, its principal office and place of business was in Aurora, Ill. Its corporate income tax returns for the taxable years 1960 to 1965, inclusive, were filed with the District Director of Internal Revenue, Chicago, Ill.

During 1964, petitioner (exclusive of its foreign subsidiaries) operated 4 manufacturing plants and 23 sales and service branches in the United States and 1 branch in Canada. It manufactured hand-held power tools, parts, and accessories for industrial, contractor, service trades, and household uses in three plants located at Aurora and LaGrange Park, Ill., and Los Angeles, Calif. (collectively the Tool Division). A fourth plant at Cincinnati, Ohio (the Rubber Division), manufactured products such as rubber-covered rolls, belts, specialty hose, and molded rubber articles. The sales and service branches were engaged in sales of power tools, parts, and accessories, and service of power tools; they did not handle rubber products.

The three manufacturing plants of the Tool Division maintained inventories of (i) raw materials; (ii) work-in-process; (iii) finished parts (for use in production of tools and for sale as service parts) and accessories; and (iv) completed tools. The manufacturing plant of the Rubber Division maintained inventories of raw materials, work-in-process, and completed products. The sales and service branches maintained inventories of service parts, accessories, and completed tools. In addition, some of petitioner's distributors and some of its large industrial customers maintained their own stocks of service parts. The

record does not disclose the extent of such inventories nor the effect they might have had on the petitioner's ability to liquidate its own inventories.

At all pertinent times prior to 1964, petitioner's inventory was valued on the basis of the lower of cost or market. Petitioner's income tax returns from 1964 to 1970 indicated that inventory continued to be valued on that basis.

From time to time, petitioner discontinued the production of certain tools but maintained an inventory of replacement parts and accessories for such tools. In 1960, petitioner opened an inventory contra account entitled, "Reserve for Inventory Valuation" (RIV). The RIV account was created for the purpose of reducing the value of closing inventory each year to reflect the value of replacement parts and accessories for tools no longer produced by petitioner.

On December 31, 1960, the RIV account was credited with $116,244.52, effecting a 100-percent writeoff of parts and accessories for tools which went out of production during and prior to 1950, a 90-percent write-down of parts and accessories for tools which were discontinued in 1951, 80 percent for 1952, et cetera, with corresponding partial write-downs for the amortization of parts and accessories for tools discontinued between 1953 and 1958 and a 10-percent write-down of parts and accessories for tools which went out of production in 1959. The effect of such a procedure was to amortize the cost of inventory of such parts and accessories over a 10-year period. An additional credit of $30,966.35 was made to the account in 1961 resulting in a balance in the RIV account on December 31, 1961, of $147,210.87. On December 31, 1963, the balance of the account was $152,117. During the first three quarters of calendar year 1964, $22,090 was added (credited) to the RIV account resulting in a balance of $174,207 as of September 30, 1964.

The credit balance in the RIV account at the end of each year was reflected on petitioner's income tax return for that year as a reduction of closing inventory. Therefore, the net addi-

tion to the RIV account during any particular taxable year increased petitioner's cost of goods sold and reduced its taxable income for that year.

In August 1964, Stewart-Warner Corp., which then owned approximately 20 percent of petitioner's outstanding common stock, entered into an agreement with petitioner to purchase substantially all of petitioner's assets. As a result of an investigation and audit conducted incident to this purchase agreement, Stewart-Warner concluded that petitioner's assets were substantially overstated and its liabilities understated. The purchase agreement was rescinded by mutual agreement in early December 1964, at which time Stewart-Warner agreed to provide management assistance to petitioner.

New management concluded that existing inventory quantities were excessive. Prior management had reflected inventory at its full value, including portions of the inventory which new management viewed to be in excess of anticipated market demand.

Incident to closing the books and preparing the financial statements as of December 31, 1964, petitioner's new management undertook an analysis of its closing inventory. A physical inventory was taken at all factories and branches. Various amounts were written off or written down, including a complete writeoff of inventory deemed obsolete. The remaining items of inventory consisted of the following:

Raw materials	4,297
Work-in-process	1,781
Finished parts (service and production) and accessories	33,670
Finished tools	4,344
Total number of inventory items	44,092

Because of the large number of remaining inventory items and the relatively small quantity or low value of each item, petitioner's new management concluded that it was impractical to

try to determine precisely how many units of each item would be sold or used. Based on its experience in the manufacturing business, its familiarity with inventory problems of manufacturing companies, and its review of the situation, petitioner's new management employed two procedures in determining units of inventory in excess of anticipated demand.

Where such information was available, under the first procedure the demand for each item of inventory in 1965 and later years was forecast in terms of 1964 sales or "usage."[3] Employing an aging schedule, gross usable inventory was then reduced as follows:

(1) Items not in excess of 12 months' anticipated demand were not written down.

(2) Items in excess of 12 months' anticipated demand but not in excess of 18 months' anticipated demand were written down 50 percent.

(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

(4) Items in excess of 24 months' anticipated demand were completely written off.

The mechanics used to forecast future requirements of the inventory items can best be illustrated by the following which shows the percentage writeoff of units of hypothetical items A, B, C, D, and E. One hundred units of each item were on hand at December 31, 1964, but the number of units sold or used in 1964 varied from 20 to 100.

3. For finished tools, usage was based on 1964 sales; for finished parts and accessories, usage was based on 1964 sales of service parts, and for parts incorporated in tools, usage was based upon 1964 production; for raw materials and work-in-process, usage was based on 1964 production.

ANTICIPATED DEMAND

Item	Units on hand at 12/31/64	Units sold or used in 1964	0-12 Months	13-18 Months	19-24 Months	+24 Months	Percent of write-down
A	100	20	20	10	10	60	
			0%	50%	75%	100%	
			0	5	7.5	60	= 72.5%
B	100	40	40	20	20	20	
			0%	50%	75%	100%	
			0	10	15	20	= 45.0%
C	100	60	60	30	10	0	
			0%	50%	75%	100%	
			0	15	7.5	0	= 22.5%
D	100	80	80	20	0	0	
			0%	50%	75%	100%	
			0	10	0	0	= 10.0%
E	100	100	100	0	0	0	
			0%	50%	75%	100%	
			0	0	0	0	= 0.0%

The second procedure employed by the new management was used to eliminate the cost of excess inventory at petitioner's LaGrange Park and Cincinnati plants, because the data showing the number of units used at those locations was not adequate to permit an accurate forecast of future requirements. Petitioner's management concluded that additional write-downs were necessary to reflect the net realizable value of its inventories at those two plants as follows: (i) 5 percent for tool parts and motor parts at LaGrange Park; (ii) 10 percent for raw material, work-in-process, and finished goods at Cincinnati, and raw material, manuals and name plates, and work-in-process at LaGrange Park; and (iii) 50 percent for hardware at LaGrange Park.

Petitioner then combined the amounts of write-down of the inventory determined by application of the two procedures described above. It did not reduce the balance in the inventory account by that amount; but, instead, entered that sum as a credit to the RIV account. The closing balance of the account on December 31, 1964, was $1,079,069 representing a net increase of $926,952 over the closing balance of the account on December 31, 1963. The December 31, 1964, balance in the RIV account resulted from the following: (i) The prior closing balance as of December 31, 1963, of $152,117, representing net additions from 1960 to 1963, inclusive, for amortization over a 10-year period of parts and accessories stocked for tools no longer produced; (ii) interim additions for the same purpose for January 1, 1964, to September 30, 1964, in the amount of $22,090; (iii) $744,030 in excess inventory determined by application of procedure 1, outlined above; and (iv) $160,832 in excess inventory determined by application of procedure 2, outlined above.

In the statutory notice of deficiency, the Commissioner reduced petitioner's 1964 net operating loss with the following explanation:

> The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954.

The adjustment did not take into account the 1964 opening balance in the RIV account in the amount of $152,117 which represented total additions claimed on prior returns. Respondent concedes that the adjustment to 1964 is excessive to the extent of such opening balance. The net adjustment to taxable year 1964 remaining in issue is, therefore, $926,952 consisting of $744,030 and $160,832 added to the RIV account as of December 31, 1964, to reflect excess inventory and $22,090 in additions to the RIV account during the first three quarters of calendar year 1964 to reflect the amortization of parts and accessories stocked for tools no longer manufactured.

At the end of each year since 1964, petitioner has reduced its ending inventory for excess items using the first procedure described above. In order to correct what it believed to be partially inaccurate results derived from application of the first

procedure, management further adjusted the value of ending inventory resulting in a $6,802 decrease in taxable income in 1970 and a $97,373 increase in taxable income in 1971.

Since late 1964, petitioner's management has not attempted to sell at reduced prices its excess parts, which comprised in each year from 70 percent to 82 percent of the excess inventory costs. The market for such parts was confined to owners of the related tools who purchased replacement parts when and if needed and would not buy parts not needed merely because of price reductions.

Petitioner reduced prices on some finished tools where management believed that price reductions would stimulate sufficient additional sales to increase its gross income. Most of the finished tools in excess supply, however, were specialized products, and petitioner's management concluded that their potential market was so limited that a price reduction would not stimulate additional sales to increase gross receipts above what they would be if the salable quantities were sold at current prices. The record does not reflect prices, dates, quantities, or other relevant details of such efforts.

Petitioner's management concluded that the only secondary market for excess work-in-process (consisting of partially completed parts or tools) was as scrap. Petitioner attempted to sell excess raw materials in 1964, but these efforts met with very little success because users of such hardware items as nuts, bolts, screws, and washers prefer to purchase them from an established supplier, who can be relied upon to furnish the items according to specifications and to warrant their quality, rather than from another manufacturer disposing of surplus in a secondary market. The record does not reflect prices, quantities, or other relevant details of such efforts.

Of the $1,079,069 balance in the RIV account at December 31, 1964, $846,960 related to inventories at Aurora, Los Angeles, and the 23 sales and service branches. Dispositions of

such inventory as scrap during the period 1965 through 1971, at the Aurora and Los Angeles factories only, amount to about 78 percent of the total inventory reserve provided for those two factories and the sales branches. Data on scrap dispositions at petitioner's branches was not presented.

Petitioner's closing inventory at December 31, 1964, contained items which, in the opinion of petitioner's management, were unsalable in the normal course of business because they were in excess of reasonably foreseeable demand. Generally accepted accounting principles required that petitioner reduce the value of its inventory to its net realizable value by eliminating the cost of such excess items. If petitioner had failed to reflect such a reduction on a reasonable basis, an independent certified public accounting firm auditing its books would have been unable to issue an unqualified opinion certifying that petitioner's financial statements had been prepared in accordance with generally accepted accounting principles. The procedures utilized by petitioner's management to reduce the value of its 1964 closing inventory, and in particular the procedures it used for eliminating the cost of excess stock, were consistent with the generally accepted accounting principle of stating inventories at the lower of cost or market, and resulted in petitioner's stating the inventory in issue at its estimate of current net realizable value.

Petitioner made no effort to determine the purchase or reproduction cost as of December 31, 1964, of each item of inventory which it determined to be excess nor was any effort made to determine the market value of each article on hand at the inventory date. Units of a given item of inventory were essentially fungible. There was no segregation or earmarking of specific units and no distinction was apparent between specific units so as to distinguish those carried at full value from those written down or written off.

At all times pertinent hereto, petitioner has utilized the reserve method for claiming losses from bad debts. For the

taxable year 1965, it claimed an addition to its reserve for bad debts in the amount of $136,150, in order to bring the balance of the reserve at yearend to $228,947.60.

In computing the addition to its reserve for the taxable year 1965, petitioner treated all intercompany accounts as fully collectible. The accounts receivable from unrelated parties at the Cincinnati Rubber Division were reviewed by personnel familiar with them. This review indicated that two accounts were uncollectible, and a 100-percent reserve was set up for them. A 1-percent reserve was set up for the remaining receivables of the Cincinnati Rubber Division.

The accounts receivable of petitioner's Tool Division were analyzed by the credit clerks responsible for those accounts. All individual accounts which had balances exceeding $100 and were more than 90 days past due were specifically evaluated as to collectibility, account by account. A 100-percent reserve was set up for those accounts which the credit personnel determined were wholly uncollectible, and for an identical ratio of the accounts which had balances of less than $100 and were more than 90 days past due. Judgments made by credit clerks responsible for the particular accounts were reviewed by the credit manager having supervision over the clerk involved, and subsequently by petitioner's treasurer. A reserve of 2 percent was set up for accounts from 30 to 90 days past due as well as those accounts over 90 days past due which were not treated as wholly uncollectible. A reserve of 1 percent was set up for accounts which were less than 30 days past due. Finally, petitioner's president conducted an overall review of the accounts receivable and approved the proposed reserve provision.

In the statutory notice of deficiency, the Commissioner disallowed $74,790.80 of the $136,150 claimed by petitioner as an addition to the bad debt reserve for the taxable year 1965. In computing the adjustment to the reserve for bad debts, respondent divided the total amount of accounts written off from 1960 through 1965 ($940,413) by the total of yearend receiv-

ables for those 6 years ($30,063,802) to arrive at a factor of 3.128 percent. He then applied this percentage to the petitioner's receivables at December 31, 1965 ($4,927,967), resulting in a figure of $154,156.80 (which is $10 too high due to a mathematical error), which respondent determined represented the allowable reserve as of that date. This amount was subtracted from the December 31, 1965, balance in the reserve account of $228,947.60 to reach the $74,790.80 adjustment.

OPINION

The Commissioner disallowed petitioner's write-down of its ending inventory for the taxable year 1964 in the amount of $1,079,069, which adjustment is now conceded to be $926,952. The statutory notice of deficiency described the adjustment to inventory affecting costs of goods sold as disallowable under section 162 or any other section of the Internal Revenue Code.

Cost of goods sold is not allowable under section 162 and petitioner need not prove that an increase in cost of goods sold is allowable under section 162. *Lela Sullenger*, 11 T.C. 1076 (1948). Cost of goods sold is an offset to gross sales. Sec. 1.61-3(a), Income Tax Regs.; cf. *Burnet* v. *Logan*, 283 U.S. 404 (1931); *Doyle* v. *Mitchell Brothers Co.*, 247 U.S. 179 (1918).

Although cost of goods sold does not represent a deduction in the technical sense, such a description of the adjustment did not mislead or surprise petitioner as to the issue involved nor has petitioner demonstrated that the language of the statutory notice was in any way prejudicial. Petitioner cannot, therefore, be sustained due to the inappropriate description of the adjustment contained in the statutory notice of deficiency. *Standard Oil Co.*, 43 B.T.A. 973 (1941), affd. 129 F. 2d 363 (7th Cir. 1942), cert. denied 317 U.S. 688 (1942); *Luke* v. *Commissioner*, 351 F. 2d 568 (7th Cir. 1965), affg. a Memorandum Opinion of this Court.

The adjustments to 1964 ending inventory which remain for our consideration consist of the following:

(1) A downward valuation of $744,030 due to excess items computed by petitioner based primarily on 1964 usage of the items;

(2) A downward valuation of $160,832 due to excess items based upon flat percentages applied to inventories at the LaGrange Park and Cincinnati plants where usage information was not available; and

(3) A downward valuation of $22,090 to reflect amortization of parts and accessories stocked for tools no longer manufactured by petitioner.

All three of the above-described procedures were employed by petitioner to reduce the value of the 1964 ending inventory to what petitioner considered to be the net realizable value. All three of the procedures were designed to write down the value because there were units on hand which management deemed to be in excess of the *future* needs of petitioner's business. There was no segregation of the inventory which management determined to be excessive.

The details of the procedures employed to compute the adjustments are described fully in our findings of fact. In summary, they may be described as follows:

(1) Petitioner assumed that future needs for each item would be the same as such needs during 1964 and determined how many months of supply thus remained on hand at December 31, 1964. The values of items on hand in excess of the forecast needs for 1 year were written down in varying percentages, depending upon the number of periods items were forecast to be used.

(2) Petitioner did not have adequate records to show the usage in 1964 of various items of inventory at its LaGrange and Cincinnati plants. Therefore, it applied arbitrary percentages in writing down specified classifications of

inventory; i.e., raw materials, work-in-process, and finished goods.

(3) For the inventory of spare parts accessories stocked for tools no longer manufactured by petitioner, it amortized the cost of such items over a 10-year period.

Respondent contends that the procedures which petitioner used to identify and value excess inventory pursuant to the 1964 write-down of such excess to net realizable value failed to clearly reflect income because such procedures were speculative, they were not sanctioned by the regulations, and would allow petitioner to circumvent annual accounting by anticipating or delaying losses which must be taken in the taxable year in which the event giving rise to the losses occurred, not the taxable year such losses are discovered. Alternatively, respondent argues that for purposes of section 446(e) of the Code, petitioner changed its method of accounting in the taxable year 1964, the year in which the first two procedures were initiated. Finally, should we hold for the petitioner on the first two theories, respondent asserts that annual accounting requires that the procedures applied to the ending inventory must be consistently applied to the beginning inventory in order to clearly reflect 1964 income.

Petitioner contends that there is no specific statutory authority contrary to the general requirements of sections 446 and 471 of the Code which require the valuation of inventory to be in accordance with generally accepted accounting principles and to clearly reflect income. Petitioner produced distinguished members of the accounting profession who testified that the inventory valuation methods employed by petitioner were in accordance with generally accepted accounting principles and thoroughly convinced us that such was the case. A write-down of inventory for excessive stock in this case was not merely desirable for accounting purposes, it was required in order to produce a certified balance sheet. Petitioner has, therefore, amply demonstrated that the write-down of inventory was in

accordance with generally accepted accounting principles and within the term, "best accounting practice," as that term is used in section 471 of the Code and the regulations promulgated under that section. However, petitioner must also show that the method clearly reflects taxable income. *Photo-Sonics, Inc.*, 42 T.C. 926 (1964), affd. 357 F. 2d 656 (9th Cir. 1966).

Two sections of the Code are involved: section 446[4] because the valuation of inventory constitutes a method of accounting and section 471[5] because that section grants authority to the Commisioner to prescribe the method for taking inventories. The sections will be discussed together because both contain the requirement that the inventory method must clearly reflect income.

Sections 446 and 471 impose a heavy burden of proof on petitioner. We described that burden as follows in *All-Steel Equipment Co.*, 54 T.C. 1749, 1761 (1970), affd. on this issue 467 F. 2d 1184 (7th Cir. 1972):

> The wording of sections 446(b) and 471 makes clear that, in matters of accounting methods, the respondent is invested with broad discretion. If a taxpayer's method of accounting does not clearly reflect income, the respondent

4. SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or *if the method used does not clearly reflect income*, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income. [Emphasis added.]

5. SEC. 471. GENERAL RULES FOR INVENTORIES.

Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and *as most clearly reflecting the income*. [Emphasis added.]

> may compute income "under such method as, in * * * [his] opinion * * * does clearly reflect income." Sec. 446(b). More specifically, section 471 provides that "inventories shall be taken * * * on such basis *as the Secretary or his delegate may prescribe* as conforming as nearly may be to the best accounting practice in the trade or business and as most clearly reflecting the income." These provisions have been a part of our tax law for many years, and they have been interpreted as imposing an extremely heavy burden of proof on taxpayers challenging the respondent's determinations—the Supreme Court has gone so far as to require a showing that such determinations are "plainly arbitrary." *Lucas* v. *Structural Steel Co.*, 281 U.S. 264 (1930). See also *Photo-Sonics, Inc.* v. *Commissioner, supra; Finance & Guaranty Co.* v. *Commissioner*, 50 F.2d 1061 (C.A. 4, 1931), affirming 19 B.T.A. 1313 (1930); *Commissioner* v. *Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738 (C.A. 2, 1968), reversing 46 T.C. 698 (1966). * * * [Emphasis supplied.]

Proof that the method is in accordance with generally accepted accounting principles does not also prove that the method clearly reflects income under the income tax law. *American Automobile Assn.* v. *United States*, 367 U.S. 687 (1961).

Petitioner does not challenge the validity of the applicable income tax regulations promulgated under sections 446 and 471. Instead, petitioner argues that the inventory valuation procedures it employed fit within the applicable regulations.[6]

6. Portions of the regulations expressing the general requirements of secs. 446 and 471 of the Code are as follows:

METHODS OF ACCOUNTING IN GENERAL

Sec. 1.446-1 General rule for methods of accounting.

(a) *General rule.* (1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. * * *

(Footnote continued on next page.)

Section 1.471-2(b), Income Tax Regs., was amended by T.D. 7285 (approved September 13, 1973), 1973-2 C.B. 163, after the briefs were filed in the instant case. The amendment deleted the following language:

> An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, *as a general rule*, be regarded as clearly reflecting his income. [Emphasis added.]

The amendment added other language which will not be set forth here because we hold that the amendment to the regulations cannot be applicable to this case. *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939). Moreover, our decision would be no different if the amendment to the regulations were applicable.

(Footnote continued from preceding page.)

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. *However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income.* A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will *ordinarily* be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year. [Emphasis added.]

Sec. 1.471-2 Valuation of inventories.

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) *It must clearly reflect the income.*

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation *so long as the method or basis used is in accord with sections 1.471-1 through 1.471-11.* [Emphasis added.]

The foregoing general provisions of the Income Tax Regulations requiring that the method must clearly reflect income were not satisfied by the testimony of petitioner's witnesses. The test in the instant case as to whether the method used by petitioner clearly reflected its income for the taxable year 1964 involves other sections of the Income Tax Regulations which are more specific in nature. Petitioner must demonstrate that its inventory method satisfied the requirements of those sections.

Petitioner, prior to 1964, valued its inventory on the basis of the lower of cost or market and it contends that its valuation of the ending inventory for 1964 was likewise valued under that method. To prevail in that contention, petitioner must show that its method came within the ambit of section 1.471-2(c) or section 1.471.4, Income Tax Regs.

Section 1.471-4, Income Tax Regs., provides as follows:

> Sec. 1.471-4. Inventories at cost or market, whichever is lower.
>
> (a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—
>
> (1) Of goods purchased and on hand, and
>
> (2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.
>
> (b) Where no open market exists or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or

others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

Substantially similar provisions have been included in the regulations since 1920. Art. 1584, Regs. 45. For purposes of section 1.471-4(a), Income Tax Regs., market has generally been held to mean replacement cost. *D. Loveman & Son Export Corp.*, 34 T.C. 776 (1960), affd. 296 F.2d 732 (6th Cir. 1961), cert. denied 369 U.S. 860 (1962); *Cleveland Automobile Co.* v. *United States*, 70 F.2d 365, 369 (6th Cir. 1934), cert. denied 293 U.S. 563 (1934). However, under exceptional circumstances and provided all requirements are complied with, inventory may be valued under the provisions of section 1.471-4(b) or 1.471(c), Income Tax Regs.

Concerning the rationale underlying the lower of cost or market method of valuing inventory, in *D. Loveman & Son Export Corp.*, supra at 798, we stated:

Whatever the defects of the lower of cost-or-market method in actual practice, its underlying theory, as stated in Finney and Miller, Principles of Accounting (Intermediate) (5th ed. 1958), is as follows (p. 251):

"The cost-or-market basis of inventory pricing conforms with an old rule of accounting conservatism often stated as

follows: Anticipate no profit and provide for all possible losses. If market purchase prices decline, it is assumed that selling prices will decline with them; reducing the inventory valuation to market purchase price reduces the profit of the period when the cost price decline took place and transfers the goods to the next period at a price which will presumably permit the earning of a normal gross profit on their sale. If the market purchase price increases, the inventory is valued at cost so that a profit will not be anticipated."

Thus, the lower of cost or market method is a limited and acceptable exception to the principles of annual accounting which otherwise would preclude recognition of an unrealized loss. *Space Controls, Inc.* v. *Commissioner*, 322 F.2d 144 (5th Cir. 1963). Of course, that does not mean that closed transactions or identifiable events may not be required in order to establish or substantiate the value of inventory. Accordingly, the Commissioner's above-quoted regulations are understandably detailed and specifically prescribe the acceptable methods for determining market value.

It is undisputed that units not in excess of projected current usage are normal goods within the meaning of section 1.471-4, Income Tax Regs. Only units in excess of projected current usage were designated by petitioner as excess inventory and written down to net realizable value. The petitioner's method of determination of excess inventory splits individual items or articles into two or more classifications for purposes of valuation. See *Fruehauf Trailer Co.*, 42 T.C. 83, 106 (1964), affd. 356 F.2d 975 (6th Cir. 1966), cert. denied 385 U.S. 822 (1966). Yet, the excess units were otherwise indistinguishable from other units of the same item of inventory. See *D. Loveman & Son Export Corp.*, 34 T.C. 776, 799 (1960), affd. 296 F.2d 732 (6th Cir. 1961), cert. denied 369 U.S. 860 (1962).

Petitioner contends that its excess inventory comes within cember 31, 1964, the inventory date; therefore, petitioner does not argue that the inventory should be valued under section

1.471-4(b), Income Tax Regs. Instead, petitioner argues that, for purposes of section 1.471-4(a), the term "market" means replacement or reproduction cost only "under ordinary circumstances." Petitioner contends that the excess inventory was an extraordinary circumstance. The record does not support such a contention. Instead, it shows that the acquisition or production of such slow-moving units was a recurring, ordinary, and necessary incident of manufacturing, marketing, and maintaining petitioner's products. Petitioner's use of the 10-year amortization of replacement parts and accessories for discontinued items began in 1960 and the practice will presumably continue because petitioner will likely cease manufacturing certain tools in the future. In addition, we think it is a fair inference from the record that petitioner's accumulation of excess inventory occurred over a period of several years.

Petitioner did not compare the replacement market value of each item with its cost to determine which was lower. Instead, it wrote down the value of the entire inventory applying arbitrary percentages. The percentages were based upon management's considered opinion as to its *ultimate salability*. We find the explanation of the percentages vague. If we were to approve a concept permitting a write-down of inventory based upon an otherwise unsupported opinion of the taxpayer as to its ultimate salability we would, within some unknown limits, permit the taxpayer to determine how much tax it wanted to pay for a given year. For obvious reasons, the percentages used by management in this case could not provide a guide for management to use in all cases. We cannot approve the percentages used in the write-down based upon the record before us. Accordingly, we hold that the three procedures utilized by petitioner in valuing its ending inventory for the taxable year 1964 do not come within section 1.471-4, Income Tax Regs.

Petitioner contends that its excess inventory comes within section 1.471-2(c), Income Tax Regs., which provides as follows:

> Sec. 1.471-2. Valuation of inventories.
>
> (c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see sec. 1.471-5.) Any goods in an inventory which are *unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes,* including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made. [Emphasis added.]

Petitioner argues that its excess inventory comes within the description of items of unsalable inventory underscored in the quoted regulations above. Such an interpretation would require us to hold that the unsalability of excess inventory resulted from causes similar to those applicable to damaged goods, imperfections, shop wear, changes of style, or odd or broken lots. We disagree with petitioner. All of the terms used in the phrase describe the units of inventory themselves and describe differences which would distinguish those units of inventory from other units of inventory. Excess inventory is not so distinguishable. It is commingled with the other inventory and it is excessive not because of its physical characteristics but because of management's view as to future demand for it. See *Cleveland Automobile Co.* v. *United States,* 70 F.2d 365, 369 (6th Cir. 1934); *D. Loveman & Son Export Corp., supra.*

Inventory falling within the categories set forth in the regulations above are to be valued by reference to actual offerings of such goods within 30 days after the inventory date. Petitioner points out its inability to comply with the 30-day provision without forcing down the price of other normal units within an item. This further demonstrates that excess inventory is not includable in the term "other similar causes" discussed above. Any goods in an inventory which are unsalable at normal prices or not usable in the normal way because of damage, imperfections, shop wear, changes of style, or odd or broken lots, would not compete in the marketplace with normal goods. They would produce a lower price and would not force down the price of normal goods because the discount in the marketplace is due to the reason that such goods are inferior.

Whether the so-called "30-day rule" applies is, therefore, not dispositive of the issue. Petitioner cannot come within the terms of section 1.471-2(c), Income Tax Regs.

Petitioner cites as authority for its procedures several cases which we find not in point for the reasons stated below.

In *Space Controls, Inc.* v. *Commissioner,* 322 F.2d 144 (5th Cir. 1963), reversing and remanding a Memorandum Opinion of this Court, the Court of Appeals reversed us to permit the write-down of work-in-process claimed by petitioner. That case involved trailers being produced pursuant to a contract for a fixed unit price. It is not necessary to decide whether we will follow that case in our consideration of the instant case because it is factually distinguishable. The price at which the finished product would be sold was fixed and the Court of Appeals found that the value placed upon work-in-process satisfied the test of section 1.471-4(b) as to a market where the taxpayer has offered the goods at a price lower than the current price. Here, petitioner made no such offer nor could it predict with any degree of accuracy what the items of excess inventory would sell for on the market in the future. In the case of applying procedure No. 1, they predicted that an item of excess inventory not used within 2 years was worth nothing but it was not based upon a fixed price 2 years away.

Petitioner relies upon *S. G. Sample Co.* v. *Commissioner,* 23 F.2d 671 (5th Cir. 1928), in which the Court of Appeals reversed the Board of Tax Appeals because it precluded the taxpayer from showing that a 25-percent general inventory markdown represented a true market value. In the instant case, petitioner was permitted to offer any evidence it desired to demonstrate the propriety of the write-down. Its evidence fails to convince us of the reasonableness of the write-down.[7]

The District Court cases relied upon by petitioner are likewise inapplicable.

In *Wood & Ewer Co.* v. *Ham,* 14 F.2d 995 (D. Me. 1926), buyers for some of the departments in a retail store who were experts in market values took inventory and testified that the values used represented the market value. Such evidence was a far cry from the instant case where arbitrary discounts were used for broad categories of inventory with no explanation of the basis for the discounts.[8]

Buck's Booterie v. *O'Malley,* an unreported case (Neb. 1951, 43 AFTR 1341, 51-2 USTC par. 9449) was a jury case.

Fides Publishers Assn. v. *United States,* 263 F.Supp. 924 (N.D. Ind. 1967), involved a concession on the part of the Government that a writeoff of unsalable inventory was proper to clearly reflect income. The taxpayer presented an accountant who testified as to the rate of writeoff and the Government produced no witness. The rate was based upon subsequent sales of items of the inventory. The rates used in the instant case were arbitrary and not explained other than being the opinion of management.

Petitioner cites four early cases of the Board of Tax Appeals.

7. *Gem Jewelry Co.,* a Memorandum Opinion of this Court dated Jan. 13, 1947.

8. *Gem Jewelry Co., supra.*

Lord Motor Car Co., 5 B.T.A. 818 (1926), involved an inventory of used cars. The taxpayer valued the cars at their cost less 25 percent to represent the costs of sale. The estimate was supported by evidence of subsequent sales at the prices used by the taxpayer. The percentages used by petitioner here were not reflected in the prices of actual subsequent sales. Instead, the percentages are unexplained theoretical discounts based upon 1 year's use of each item in procedure No. 1 and upon flat percentages without explanation in procedure No. 2.

No reasons are given for approval of the method used by the taxpayer in *Fred S. Stewart Co.*, 5 B.T.A. 436 (1926). The opinion merely approves the valuation method used by the taxpayer, presumably on the basis of the facts.

May Lumber Co., 13 B.T.A. 62 (1928), involved a write-down of inventory for deterioration based upon years of actual experience. The Board allowed the write-down because it was based upon precise and accurate physical count and evaluation, not unexplained percentages used by petitioner herein.

Justus & Parker Co., 13 B.T.A. 127 (1928), is likewise inapplicable. That case involved a careful itemized valuation of each item of inventory by employees of the taxpayer, not broad applications of percentages as we have here.

The cases cited by petitioner and distinguished above fail to convince us that petitioner's method of valuing inventory clearly reflected income for tax purposes. Our holding herein does not disapprove of the use of percentages, per se; it disapproves those used by petitioner herein.

Because we hold that the adjustments of $926,952 to ending inventory on December 31, 1964, did not result in a clear reflection of taxable income for petitioner's taxable year 1964, it follows that the Commissioner did not abuse the discretion granted him by section 471 of the Code by reducing petitioner's cost of goods sold and restoring such amount to income. Alternative grounds relied upon by respondent will not be considered because we hold for him on the inventory issue for the reasons stated above.

Petitioner claimed a deduction of $136,150 as an addition to its reserve for bad debts for the taxable year 1965, which the Commissioner disallowed to the extent of $74,790.80. Petitioner's deduction was based upon analyses of its accounts receivable by its appropriate personnel. The reserve determined by the Commissioner was based upon an average of the taxable year 1965 and the preceding 5 years. The procedure adopted by the Commissioner is based upon *Black Motor Co.*, 14 B.T.A. 300 (1940), affd. on another issue 125 F.2d 977 (6th Cir. 1942).

An addition to a reserve for bad debts is permitted under the provisions of sections 166(c) of the Code.[9] The applicable regulations are contained in portions of section 1.166-4, Income Tax Regs.[10]

---

9. SEC. 166. BAD DEBTS.

(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

10. Sec. 1.166-4 Reserve for bad debts.

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of sec. 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

Section 166(c) gives the Commissioner the discretion to adjust the reserve for bad debts. To prevail, petitioner must show that the Commissioner abused such discretion. Petitioner contends that the abuse occurred because the Commissioner based his determination upon past history rather than current data on collectibility.

The burden on petitioner was to show that the Commissioner's determination was arbitrary, not that petitioner's method was better. *Massachusetts Business Development Corp.*, 52 T.C. 946 (1969). Petitioner did not show that conditions at the end of 1965 would cause collection of accounts receivable to be less likely than in prior years. We infer from the entire record that collectibility was probably more likely at the end of 1965 than it was in at least some of the years upon which the Commissioner based his average because new management had been infused into petitioner.

We hold, therefore, that the Commissioner did not abuse his discretion under section 166(c) of the Code in disallowing petitioner's deduction for addition to its reserve for bad debts in the amount of $74,790.80 for the taxable year 1965.

Decision will be entered under Rule 155.

OPINION BY JUDGE TONE

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

September 29, 1977.

Before

Hon. PHILIP W. TONE, *Circuit Judge*
Hon. HARLINGTON WOOD, JR., *Circuit Judge*
Hon. WILLIAM J. CAMPBELL, *Senior District Judge**

THOR POWER TOOL COMPANY,
Petitioner-Appellant,

No. 76-1476 *vs.*

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the Tax Court of the United States.

This cause came on to be heard on the transcript of the record from the United States Tax Court and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the United States Tax Court in this cause appealed from be, and the same is hereby, AFFIRMED, with costs, in accordance with the opinion of this court filed this date.

* The Honorable William J. Campbell, Senior District Judge of the United States District Court for the Northern District of Illinois, is sitting by designation.

IN THE UNITED STATES COURT OF APPEALS
For the Seventh Circuit

No. 76-1476

THOR POWER TOOL COMPANY,
Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court.
William A. Goffe, *Judge.*

Argued December 7, 1976—Decided September 29, 1977

Before TONE and WOOD, *Circuit Judges,* and CAMPBELL, *Senior District Judge.**

TONE, *Circuit Judge.* Thor Power Tool Company appeals from a decision of the United States Tax Court, 64 T.C. 154 (1975), which upheld the Commissioner's disallowance of portions of Thor's write-down of its closing inventory for 1964 and its 1965 addition to a reserve for bad debts.[1] The issues

* The Honorable William J. Campbell, Senior District Judge of the United States District Court for the Northern District of Illinois, is sitting by designation.

1. Because the extensive write-downs taken for 1964, see text, *infra,* resulted in an operating loss for that year, part of which was carried back to 1963, the tax deficiency resulting from the Commissioner's disallowance was for 1963. The bad debt reserve issue relates to the taxes for 1965.

presented involve the income tax treatment of "excess" inventory and the method for calculating a reasonable addition to a bad debt reserve. We affirm.

I. *Inventory.*

A.

Thor manufactures tools and parts at three plants in its Tool Division and various rubber articles at a fourth plant in its Rubber Division. The corporation also maintains 24 sales and service branches in the United States and Canada. Inventories of parts, accessories, and completed tools are maintained at all branches and at the three Tool Division plants. Those three plants also maintain inventories of raw materials and work-in-process. The single Rubber Division plant keeps inventories of raw materials, work-in-process, and completed products.[2] Much of the inventory consists of replacement parts and accessories.

When Thor discontinued the manufacture of tools of a particular model, it nevertheless continued to stock replacement parts and accessories for tools of that model that were still in service. Thor began amortizing its cost of inventories of replacement parts and accessories for out-of-production tools in its 1960 tax return. This was accomplished by establishing an inventory contra account on the books of the company, and crediting that account with ten percent of the value of a part or accessory for each year since the termination of production of the tool of which the part or accessory was a component. The closing inventory was then written down to reflect this account, thereby increasing the cost of goods sold and reducing the reported net income. This practice was continued in the 1961, 1962, 1963 tax returns, without a challenge from the Commissioner. Further

2. The Tax Court observed that inventories of undetermined size were also maintained by Thor's distributors and several major customers. None of those inventories are involved in this case.

additions to the account were made for the first three quarters of 1964.[3]

In December of 1964 new management assumed the reins at Thor.[4] As part of its preparation of the 1964 financial statements, "a complete re-evaluation of the assets and liabilities of the company" was undertaken, including "a physical inventory . . . at all locations . . . ." The inventory was then "priced at 1964 inventory standards . . . ." [Tr. 90-91.] Once this was completed the management began to adjust the inventory valuation, in order to show the inventory at its "net realizable value," as required by the standards of the accounting profession, and to price the inventory at "the lower of cost or market," as had been Thor's practice for income tax purposes.

Write-downs totaling about $2,750,000 were made for obsolescence[5] and other reasons. These were not questioned by the Commissioner, because the items in question were scrapped soon after they were deleted from the 1964 closing inventory. A write-down of $245,000 was made for parts for three recent products that had not sold as well as expected. This too went unchallenged because the products were sold at lowered prices soon after the write-down.

The remaining inventory, consisting of some 44,000 items, was evaluated for the purpose of ascertaining the extent to which

3. A total of $152,117 was credited to the inventory contra account, and hence subtracted from net income, during 1960-63. Another $22,090 was credited to the account during the first three quarters of 1964, for subtraction at the close of that year.

4. A proposed merger of Thor into Stewart-Warner Corp. fell through in early December 1964, apparently because an investigation and audit convinced Stewart-Warner that Thor's assets were overstated. The purchase agreement between the two companies was rescinded by mutual agreement at that time, and Stewart-Warner agreed to provide management assistance to Thor. Accordingly, a Stewart-Warner employee assumed the presidency of Thor on December 14, 1964.

5. All parts of tools which had never been offered for sale and parts for which there had been no demand during 1964 were considered to be "obsolete."

it too was in excess of anticipated demand. Relying on its experience with manufacturing businesses, the new management estimated future demand for these items. At two of the Tool Division plants, estimates were based on 1964 sales figures, resulting in write-downs of $744,030.[6] Owing to the inadequacy of sales data for the other two plants, flat percentage adjustments were made to the valuations for parts, raw materials, work-in-process, and finished products in the physical inventory, resulting in write-downs of $160,832.[7] The $22,090 credit which the old management had entered in the inventory contra account for the first three quarters of 1964, see note 3, *supra,* was also subtracted from closing inventory.

These last three adjustments were disallowed by the Commissioner, as not "clearly reflecting the income" for 1964.[8] The

6. The gross usable inventory at these plants was reduced as follows:

(1) Items not in excess of 12 months' anticipated demand were not written down.

(2) Items in excess of 12 months' anticipated demand but not in excess of 18 months' anticipated demand were written down 50 percent.

(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

(4) Items in excess of 24 months' anticipated demand were written off completely.

7. Inventory was reduced by: (1) five percent for tool parts and motor parts at the third plant; (2) ten percent for raw materials, manuals and name plates, and work-in-process at this plant; (3) fifty percent for hardware at this plant; and (4) ten percent for raw materials, work-in-process, and finished goods at the fourth plant.

8. The statutory notice of deficiency received by Thor initially indicated a disallowance of $1,079,069, which was the total credit balance in Thor's inventory contra account at the close of 1964. This figure was derived by adding the above described credits to the account taken during 1964, which totaled $926,952, to the year-end 1973 account credit balance of $152,117.

The credit balance in the inventory contra account at the end of each year was reflected on Thor's income tax return for that year as a reduction of closing inventory. Thus, only the net addition to the

(Footnote continued on next page.)

Tax Court upheld the Commissioner, on the ground that Thor's write-down of excess inventory was not permitted by the Treasury Regulations.

B.

Section 446 of the Internal Revenue Code, 26 U.S.C. § 446, provides that taxes shall be computed in accordance with the taxpayer's usual method of accounting, unless that method does not clearly reflect income.[9] The taxpayer's method of accounting is thus given preference. *Lincoln Electric Co.* v. *Commissioner*, 444 F.2d 491, 494 (6th Cir. 1971); *Photo-Sonics, Inc.* v. *Commissioner*, 357 F.2d 656, 658 n.1 (9th Cir. 1966). If, however, in the opinion of the Commissioner, that method does not clearly reflect income, the Commissioner may require that another method be used. *Brown* v. *Helvering*, 291 U.S. 193, 203 (1934); *Bangor Punta Operations, Inc.* v. *United States*, 466 F.2d 930, 935 (7th Cir. 1972).[10] The Commissioner possesses "broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Commissioner* v. *Hansen*, 360 U.S. 446, 467 (1959).

(Footnote continued from preceding page.)
account during any particular taxable year increased Thor's cost of goods sold and reduced its taxable income for that year. Inasmuch as the Commissioner was only challenging Thor's 1964 return, yet the deficiency notice also included the 1964 opening balance, the Commissioner conceded before the Tax Court that only the credits totaling $926,952 were at issue. The Commissioner did not, however, concede the propriety of the methods by which the 1964 opening account credit balance was obtained. We express no views on this.

9. 26 U.S.C. § 446:

> ". . . Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books . . . [unless] the method used does not clearly reflect income, [in which case] the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

10. Treas. Reg. § 1.446-1(a)(2) provides, *inter alia*, that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income."

The Commissioner's discretion is, if anything, greater with respect to inventory accounting. *Waukesha Motor Co.* v. *United States*, 322 F.Supp. 752, 768 (E.D. Wis. 1971). Section 471, 26 U.S.C. § 471, provides:

> "Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The statute thus sets up a two-part standard on which the Secretary or his delegate, the Commissioner, is to act: the taxpayer's inventory method must both conform closely to the relevant "best accounting practices" and clearly reflect income. These two are usually linked, however, because an accounting method which "reflects the consistent application of generally accepted accounting principles in a particular trade or business . . . will ordinarily be regarded as clearly reflecting income . . . ." Treas. Reg. § 1.446-1(a)(2). The same principle was applied to inventory accounting in a sentence which appeared in the regulations until 1973:

> "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of a taxpayer can, as a general rule, be regarded as clearly reflecting his income."

Treas. Reg. § 1.471-2(b).[11] See also *Commissioner* v. *Joseph E. Seagram & Sons, Inc.*, 394 F.2d 738, 742-743 (2d Cir. 1968).

As the words "ordinarily" and "as a general rule," and the two-part standard itself, suggest, however, there can be circum-

11. In 1973 this sentence was deleted by an amendment which the Tax Court properly held inapplicable to the case at bar. That amendment also added the requirement that accounting methods be "consistent with" the regulations to Treas. Reg. § 1.446-1(c)(1)(ii). See T.D. 7285 (approved Sept. 13, 1973), 1973-2 Cum. Bull. 163.

stances in which the best accounting practice does not clearly reflect income. Thus the accounting profession's indorsement of a practice as "the best accounting practice," even if accepted by the Commissioner, does not require him to determine that the practice clearly reflects taxable income. *Schlude* v. *Commissioner*, 372 U.S. 128 (1963); *American Automobile Association* v. *United States*, 367 U.S. 687, 693 (1961). This is because the goals of balance-sheet and income-tax accounting are not identical. Mr. Justice Clark, in *American Automobile Association* v. *United States*, *supra*, speaking of the accounting system before the Court, said that it "presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner." 367 U.S. at 692. The criteria referred to were stated by Justice Brandeis in *Lucas* v. *Kansas City Structural Steel Co.*, 281 U.S. 264, 268 (1930):

> "The Federal income tax system is based upon an annual accounting period. This requires that gains or losses be accounted for in the year in which they are realized. The purpose of the inventories is to assign to each period its profits and losses."

Whether a given method of accounting clearly reflects income is a question of fact. *Artnell Co.* v. *Commissioner*, 400 F.2d 981, 983-985 (7th Cir. 1968). As the Supreme Court has stated, it is not our role, in reviewing the Commissioner's exercise of his discretion, "to weigh and determine the relative merits of systems of accounting." *Brown* v. *Helvering*, *supra*, 291 U.S. at 204-205. Thus, in order to overturn the Commissioner's disallowance, the taxpayer must show that the Commissioner's act was "plainly arbitrary." *Lucas* v. *Kansas City Structural Steel Co.*, *supra*, 281 U.S. at 271; *Bangor Punta Operations, Inc.* v. *United States*, *supra*, 466 F.2d at 935.

C.

The Tax Court held in this case that under § 471 of the Internal Revenue Code of 1954 the Secretary is to prescribe the

methods by which inventories are to be taken, and that the Treasury Regulations set forth those methods. While the court found that Thor's write-downs of excess inventory constituted a "best accounting practice" within the terms of the statute, it also held, without elaboration, that Thor had failed to establish that its inventory accounting clearly reflected its 1964 income, thus falling outside the general language of the regulations. The Tax Court therefore required Thor to demonstrate that its method satisfied one of the specific regulations. Because the regulations did not authorize Thor's treatment of its "excess inventory," the court upheld the Commissioner.[12] Thor argues that the Tax Court erred in not allowing it to take advantage of a "presumption" that best accounting practice will clearly reflect income. Thor contends this was created by the sentence formerly included in Treas. Reg. § 1.471-2(b). See text at note 11, *supra*. Thor also argues that the court erred in requiring it to demonstrate that its inventory accounting was explicitly authorized by the regulations, and in holding that the regulations did not authorize the method used.

The Tax Court's finding that Thor's treatment of inventory for 1964 conformed to best accounting practice is not clearly erroneous and is not seriously challenged by the Commissioner. The remaining issues relate to whether that treatment most clearly reflected income and can best be discussed in the following sequence: (1) Was Thor's treatment authorized by specific regulations? (2) Was it authorized by general regulations? (3) If it was neither authorized nor forbidden by any regulations, and the Commissioner nevertheless was required to determine

12. The Tax Court therefore did not reach the Commissioner's alternative arguments, *viz.*, that Thor's new inventory valuation procedures constituted a change in its method of accounting, without the Commissioner's permission, and was therefore impermissible, or that Thor's 1963 income was not clearly reflected because it failed to revalue its 1964 opening inventory in accordance with the methods used to value its closing inventory.

whether it clearly reflected income,[13] did he abuse his discretion in determining that it did not? We answer these questions in the negative and then go on to hold, see (4), *infra*, that the Commissioner did not abuse his discretion in determining that inventory which was not yet scrapped could not be written off for tax purposes.

(1)

We uphold the Tax Court's determination that Thor's write-downs of excess inventory did not fall within the specific regulations. Treasury Regulation § 1.471-2(c) permits the taxpayer to use special valuation procedures for inventory goods which the taxpayer proves are "unsalable at normal prices . . . because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes . . . ." Thor failed to carry its burden of proving that its excess parts and accessories were within the descriptive phrase. *E. W. Bliss Co.* v. *United States*, 224 F.Supp. 374, 378 n.1 (N.D. Ohio 1963), *aff'd on the opinion below*, 351 F.2d 449 (6th Cir. 1965). We accept the view of the Commissioner and the Tax Court that the words "other similar causes" do not extend the coverage of the regulation to units which, in management's opinion, are "excess." As the Tax Court observed, excess inventory is not distinguishable from other units of inventory. All the tool parts and accessories were in essentially the same condition—they were commingled and interchangeable. See *Lucas* v. *Kansas City Structural Steel Co., supra*, 281 U.S. at 270-271. See also *Cleveland Automobile Co.* v. *United States*, 70 F.2d 365, 368-369 (6th Cir.), *cert. denied*, 293 U.S. 563 (1934). Moreover, at least with respect to the finished products, Thor did not meet the valuation requirements of this regulation. No "actual offering" at below "normal prices" was made within 30 days of the inventory, and therefore no bona fide selling price could be calculated.[14] Thor cannot be permitted to do what the Sixth Circuit forbade in *Cleveland Automobile Co.* v. *United States, supra, viz.*,

> "by a consideration of all factors then known and those later discovered . . . thus substitute for the actual selling price required by the regulation a suppositious selling price which the Commissioner and the court must accept because it conforms to good accounting practice."

70 F.2d at 369. See also *John L. Ashe, Inc.* v. *Commissioner*, 214 F.2d 13, 15 (5th Cir. 1954).

Nor does the excess inventory come within Treas. Reg. § 1.471-4.[15] As noted above, the units of excess inventory are "normal" goods, unlike the custom-built presses involved in the *Bliss* case, on which Thor chiefly relies. The fact that they may be in excess of Thor's future needs is not an exceptional circumstance permitting their market valuation to be set at other than their replacement cost. *Knapp King-Size Corp.* v. *United States*, 527 F.2d 1392, 1399-1400 (Ct. Cl. 1975); *D. Loveman & Son Export Corp.* v. *Commissioner*, 34 T.C. 776 (1960), *aff'd on opinion below*, 296 F.2d 732 (6th Cir. 1961), *cert. denied*, 369 U.S. 860 (1962). Thor's own chief executive officer stated that "any business which is involved in the manufacture and sale of products inevitably must have excess inventory," that this was particularly true in "the kind of business that

13. We assume that if a particular situation is not covered by a general or specific regulation, the Commissioner would nevertheless be obligated to apply the two-part standard to the facts of that case. Section 471, in speaking of the individual taxpayer, suggests as much.

14. Treasury Regulation § 1.471-2(c) provides that unsalable goods "should be valued at bona fide selling prices less direct cost of disposition . . . . Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date."

15. This regulation governs inventories valued at the lower of cost or market, as was Thor's. Subsection (a) provides the general definition of "market," which applies "[u]nder ordinary circumstances and for normal goods in an inventory . . . ." Subsection (b) establishes procedures for inventory valuation "[w]here no open market exists or where quotations are nominal, due to inactive market conditions . . . ." In such circumstances "the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales . . . or compensation paid for cancellation of contracts . . . ."

Thor was in . . . which involves a very high percentage of service parts and accessories," and that many manufacturing costs are "independent of quantity." [Tr. 95-97.] Furthermore, a senior member of a leading accounting firm who was called as an expert by Thor testified that "most corporations in that type of business do carry a fairly good inventory in terms of quantities and diversified parts for most of their models . . . ." [Tr. 349.] Thus, in Thor's business it was considered wise to produce in advance all the parts that were expected to be sold over several succeeding years.[16] Of necessity, these parts were then carried in inventory. Therefore, we cannot say that the Tax Court erred in holding that the accumulation of excess inventory is not an extraordinary circumstance justifying valuation of inventory under Treas. Reg. § 1.471-4(b) in a manufacturing business such as Thor's, with its extensive inventory accumulated for service and repair purposes.[17]

(2)

As we have noted, the regulation dealing with accounting practices generally, Treas. Reg. § 1.446-1(a)(2), and the former provision in the regulation dealing with inventory, Treas. Reg. § 1.471-2(b), simply provide that the best accounting practice will ordinarily produce a result that most clearly reflects income. Thor contends that these provisions established a presumption in its favor. The weakness in this argument is exposed, however, by the sentence in the latter regulation which immediately precedes the sentence on which Thor relies. That preceding sentence is as follows:

16. As the American Institute of Certified Public Accountants observed in a comment it prepared on proposed amendments to the inventory regulations under § 471, "the cost of producing additional parts, in the event that actual future need is greater than presently estimated, would be prohibitive." [Ex. 29, pp. 4-5.]

17. Our conclusion is consistent with the AICPA's acknowledgment in its statement on proposed inventory regulations, see note 16, *supra*, that "the problem of determining appropriate cost for inventory quantities in excess of prospective demand" is "[a]n important valuation matter not covered" by the present regulations.

> "In order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is in accord with sections 1.471-1 through 1.471-11."

The Tax Court, although it did not reach the related issue of internal inconsistency during 1964, see note 12, *supra*, did infer that the excess inventory Thor attempted to write off in 1964 had been accumulated "over a period of several years." This inference was appropriate, in view of the fact that the merger with Stewart-Warner was called off in part because Thor's inventory valuation was excessive, see note 4, *supra*, and the fact that the new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years. As the Tax Court implied in questioning an expert witness called by Thor, this large discrepancy was enough to indicate that consistency was lacking. [Tr. 371-375.] Hence if any "presumption" was created by the regulations, it was dissipated by this lack of consistency. Inventory accounting for income tax purposes must serve the ultimate goal of matching costs and revenues so the profit or loss of a particular year is accurately reflected. *United States Cartridge Co.* v. *United States*, 284 U.S. 511, 520 (1932); *Photo-Sonics, Inc.* v. *Commissioner, supra*, 357 F.2d at 657. Thus Thor had the burden of proving before the Tax Court that its treatment of inventory more clearly reflected income than did the Commissioner's. *Peterson Produce Co.* v. *United States*, 205 F.Supp. 229, 241 (W. D. Ark. 1962), *aff'd*, 313 F.2d 609 (8th Cir. 1963).

(3)

The Tax Court's finding that Thor did not prove its 1964 income to have been clearly reflected was not clearly erroneous. *Cf. Resnik* v. *Commissioner*, 555 F.2d 634, 636 (7th Cir. 1977). Thor's argument to the contrary is not supported by the

expert testimony it adduced. The highly qualified members of the accounting profession Thor called as experts did not testify that its 1964 income had been clearly reflected in its tax return, or that the accounting method used was necessary in order to state the 1964 income. Thor's independent auditor (who did not become such until 1970) testified merely that his analysis of Thor's 1964-1971 inventory reserves and results of operations demonstrated that Thor's write-offs of "excess inventory" were not excessive. [Tr. 162-167.] Neither his testimony nor that of the other experts compelled a finding that the Commissioner had abused his wide discretion.

(4)

Inventory valuation under the lower-of-cost-or-market method adopted by Thor is "a limited exception to the principle of annual accounting." *Space Controls, Inc.* v. *Commissioner,* 322 F.2d 144, 148 (5th Cir. 1963). In conceding that exception, however, the Commissioner has not abandoned completely the rules that require realization. Thus, the Commissioner requires taxpayers to prove "closed transactions or identifiable events" as a basis for inventory valuations, in order to reduce their opportunities to determine unilaterally how much profit or loss to report in any given year. This is the purpose of Treas. Regs. §§ 1.471-2(c) and 1.471-4(b), which require the taxpayer to offer evidence of valuation, such as discount sales or contract cancellations. Accounting principles may well require that reserves be maintained to reflect declines in value of goods held in inventory, despite the absence of such "identifiable events." But, as Mr. Justice Brandeis observed in *Brown* v. *Helvering, supra,* 291 U.S. at 201-202:

> "Only a few reserves voluntarily established as a matter of conservative accounting are authorized by the Revenue Acts. . . . Many reserves set up by prudent business men are not allowable as deductions."

See also *American Can Co.* v. *Bowers,* 35 F.2d 832, 835 (2d Cir. 1929), *cert. denied,* 281 U.S. 736 (1930). See generally *United States* v. *American Can Co.,* 280 U.S. 412, 419 (1930);

Lucas v. *American Code Co.,* 280 U.S. 445, 452 (1930). In exercising his broad discretion under § 471, the Commissioner may require that the losses on excess inventory actually be realized, *e.g.,* through scrapping, before they may be subtracted from sales.[18] That is apparently what he required in this case, as is demonstrated by his allowance of the $245,000 write-down for excess inventories of three products that Thor actually sold off at lower prices. [Tr. 70, 99, 109.] Accordingly, we affirm the judgment of the Tax Court with respect to the inventory valuation issue.

II. *Bad Debt Reserve*

The second issue before us involves Thor's 1965 addition to its reserve for bad debts. At the close of 1965 the collectibility of all accounts receivable was estimated by the Thor personnel most familiar with each account and their estimates were reviewed by three levels of management. All inter-company accounts were treated as fully collectible. A 100 percent reserve was established for the two Rubber Division accounts determined to be wholly uncollectible, and a one percent reserve was established for the remaining receivables in that division. The credit clerks in the Tool Division evaluated each 90-day-old account of over $100, and made an individual determination as to its collectibility. Again a 100 percent reserve was set aside for those accounts which were considered wholly uncollectible. The dollar ratio of uncollectible accounts to total over-$100 accounts was then applied to the 90-day-old accounts with a balance of under $100, to determine the dollar reserve to be set aside on these smaller accounts. Flat two percent reserves were set aside for all other 90-day-old accounts and all accounts between 30 and 90 days past due. A one percent reserve was established for all accounts less than 30 days old.

18. Compare, as to obsolete goods, *C-O-Two Fire Equipment Co.* v. *Commissioner,* 219 F.2d 57 (3d Cir. 1955). The distinction is understandable in light of the fact that the regulations specifically allow deductions for obsolete property. See *United States Cartridge Co.* v. *United States,* 284 U.S. 511, 516-520 (1932).

These computations resulted in a total addition to the bad debt reserve, *i.e.*, a total deduction from income, of $135,150. The Commissioner, however, recomputed what he considered to be "a reasonable addition" to the reserve, by applying the six-year moving average, or *Black Motor* formula to the 1965 accounts receivable.[19] He divided the total of accounts written off by Thor during the tax year in question and the five preceding years by the total of year-end receivables for all six years. The resulting percentage was then applied to the 1965 year-end receivables, and the $74,790.80 by which Thor's claimed deduction exceeded the product of this calculation was disallowed.

Reasonable additions to a reserve for bad debts may be deducted pursuant to § 166(c) of the Internal Revenue Code of 1954.[20] As the Code makes clear, the Commissioner is to exercise his discretion regarding the reasonableness of any particular addition. In order to overturn the Commissioner's disallowance, therefore, the taxpayer must show that the Commissioner has abused his discretion. *Calavo, Inc.* v. *Commissioner,* 304 F.2d 650, 653-654 (9th Cir. 1962). This is a "heavy burden." *Consolidated-Hammer Dry Plate & Film Co.* v. *Commissioner,* 317 F.2d 829, 834 (7th Cir. 1963). As we have stated before, the issue thus presented "is whether the Commissioner's view is reasonable." *The First National Bank of Chicago* v. *Commissioner,* 546 F.2d 759, 761 (7th Cir. 1976), *cert. denied,* 97 S.Ct. 2176 (1977); *S. W. Coe & Co.* v. *Dallman,* 216 F.2d 566, 569 (7th Cir. 1954). If it is, the inquiry is ended. We agree with the Tax Court that the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable.

AFFIRMED.

---

19. The procedure is described in *Black Motor Co.,* 14 B.T.A. 300 (1940), *aff'd on other grounds,* 125 F.2d 977 (6th Cir. 1942).

20. 26 U.S.C. § 166(c) provides:

> "*Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts."

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

BRIEF FOR AMICUS CURIAE CHAMBER OF COMMERCE OF THE UNITED STATES IN SUPPORT OF PETITION

ALLAN B. MUCHIN
FRANCIS X. GROSSI, JR.
ROBERT S. CONNORS
KATTEN, MUCHIN, GITLES, ZAVIS
PEARL & GALLER
4100 Mid-Continental Plaza
55 East Monroe Street
Chicago, Illinois 60603
(312) 346-7400
Counsel for Amicus Curiae Chamber of Commerce of the United States

Of Counsel:
LAWRENCE B. KRAUS
General Counsel
Chamber of Commerce of the
United States of America
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6036

STANLEY T. KALECZYC, JR.
Director of Litigation
National Chamber Litigation Center
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6218

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

TABLE OF CONTENTS

Table of Authorities

Cases:

Statutes:

Treasury Regulations:

Miscellaneous:

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR AMICUS CURIAE CHAMBER OF COMMERCE OF THE UNITED STATES IN SUPPORT OF PETITION

STATEMENT OF INTEREST

The Chamber of Commerce of the United States ("the Chamber") is a nonprofit corporation organized and existing under the laws of the District of Columbia. The Chamber is the largest business federation in the United States. Its membership consists of over 67,000 businesses, the great majority of which are corporations, and more than 3,700 state and local chambers of commerce and trade associations, which in turn have numerous corporate members. Many of these corporations are engaged in the manufacture or distribution of goods for which an inventory of replacement parts is an essential business practice.

The *Thor* case raises, for the business and accounting communities, the important issue of the effect to be accorded generally accepted accounting principles in the valuation of inventories, under a statutory scheme requiring a method which embodies both the best accounting practice and the clear reflection of income. Because inventory valuation is invariably an accounting function and a sensitive element in the equation for deriving tax liability, unresolved questions presented here concerning the influence and significance of accepted accounting principles in federal taxation are a matter of compelling consequence. The decision reached below, affirming the disallowance of an accepted and rational formula for valuing inventory of replacement parts, has profound implications upon commerce, including such industries as automobile, appliance, industrial machinery and the like. Indeed, the issues here strike virtually every business maintaining a quantity of various replacement parts for the products it manufactures or distributes, whether toasters or nuclear generators. Moreover, as the Brief of the National Association of Manufacturers *Amicus Curiae* makes abundantly clear, the impact on litigation incident to enforcement of the revenue laws in issue has been substantial.

Coupled with substantial policy and practical considerations dictating review by this Court, there are significant issues relating to the statutory interpretation of Section 471 of the Internal Revenue Code and inherent inconsistencies between four Circuit Courts of Appeal. The Seventh Circuit reached an erroneous result in regard to each issue and, indeed, misconstrued the applicable regulations themselves. Any one of these elements would warrant review. Cumulatively they command it.

REASONS FOR GRANTING THE WRIT

1. This Court Should Resolve the Chronic Issue of the Relation Between Accepted Accounting Principles and the Clear Reflection of Taxable Income.

The most significant issue presented by this case is whether and to what extent a business taxpayer may rely upon sound and accepted commercial accounting standards to report taxable income, a problem that increasingly confronts every business. Resolution of that issue turns on the questionable premise of the decision below that, with no statutory or regulatory basis, recognized commercial accounting principles may be swept aside solely because of some obscure dissimilarity with tax accounting.

It is vital to businesses of every size and type that their financial results be accurately reported. The precise calibration of income, in particular, is an essential ingredient of major decision-making and is indispensable in assessing the health of a business. Rules of accounting have evolved with the singular objective of furnishing a stable and uniform gauge upon which business depends for internal and comparative judgments. Nevertheless, and despite a statutory commitment to accounting principles applicable here, the Seventh Circuit displaced a valid accounting principle because it differed in some undefined fashion from tax accounting. As the result, a business taxpayer is left at sea to rely upon an income measured by accepted accounting principles which may be freely undone by the Commissioner solely because of a supposed but unarticulated distinction between commercial and tax accounting. The revenue laws are too influential a factor in our economy to admit of such a standardless administration.

Contrary to the view expressed by the Seventh Circuit (A. 39-40),[1] commercial accounting cannot be considered alien to the Internal Revenue Code, especially in this context. In Section

1. "A" references are to the Appendix to taxpayer's petition filed herein, in which the opinion of the Seventh Circuit is reprinted.

446,[2] Congress adopted the general proposition that a taxpayer's method of accounting shall control the tax determination so long as income is not distorted. With respect to inventories specifically, the Code directs the Commissioner to prescribe only those valuation methods which conform "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." I. R. C. § 471. As is demonstrated in Point 4, *Infra*, the method of inventory valuation utilized by the taxpayer here represented a realistic formulation of market value authorized by the relevant statute and its regulation. Yet, notwithstanding the fact that the governing statute confers equal status on commercial accounting principles and the clear reflection of income, the Seventh Circuit decision rejecting that valuation method is predicated on an asserted disparity between commercial and tax accounting. This produces genuine and disturbing confusion for the business taxpayer as to the relation between an accepted accounting principle and the clear reflection of income.

Resolution of that confusion requires analysis of the real distinctions between commercial and tax accounting, not the illusory ones. The antiquated and doctrinaire notion that commercial accounting principles may be readily discarded because they relate to conventional financial reporting is simply unrealistic. In the investment market, where the credibility of certified financial statements is acutely expected, there is signal emphasis upon the accuracy of annual earnings.[3] Despite the suspicion engendered by a difference which the Seventh Circuit could not or did not describe, it is unreasonable to deny that

2. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1954, 26 U. S. C. §§ 1 *et seq.* (1970). The relevant provisions are set forth in the Appendix to taxpayer's petition.

3. The accounting profession has repeatedly subscribed to the paramount interest in assuring that accounting principles render an accurate income statement. AICPA Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", ch. 2, ¶ 12 (1970); AICPA Accounting Research Bulletin No. 43, "Introduction", ¶ 3 (1953).

commercial and tax accounting share common objectives. It is equally arbitrary to dismiss accepted accounting principles simply on the shallow assertion of this undescribed difference. In the end, this claim of difference has become so entrenched that its mere assertion, according to the Commissioner, authorizes him to insulate his action from challenge. That assertion was accepted by the Seventh Circuit here.

Historically, a majority of this Court in two closely divided decisions, has rejected accepted accounting principles in the narrow area of prepaid income and required income to be reported in the year of receipt to prevent distortion of income. *Schlude* v. *Commissioner*, 372 U. S. 128 (1963); *American Automobile Ass'n.* v. *United States*, 367 U. S. 687 (1961).[4] On the other hand, principles for the obverse issue of liabilities incurred with the creation of income have been sanctioned, despite the Commissioner's repeated insistence that it distorts income. *Gillis* v. *United States*, 402 F. 2d 501 (5th Cir. 1968); *Denise Coal Co.* v. *Commissioner*, 271 F. 2d 930, 934-937 (3rd Cir. 1959); *Pacific Grape Products Co.* v. *Commissioner*, 219 F. 2d 862 (9th Cir. 1935). There is, in short, a decisive conflict in the permissible treatment of current income and current expenses. The identical accounting theory permitted

4. The majority opinion of Justice Clark was joined by Chief Justice Warren and Justices Black, Brennan, and White. The dissenting opinion of Justice Stewart was joined by Justices Douglas, Harlan and Goldberg. In the dissenting opinion of Justice Stewart, the following statement respecting the statutory predecessor of Section 446—a view which the majority opinion did not expressly repudiate—cogently describes the critical issue in this case:

> I think the Government's position in this case is at odds with the statutes, regulations, and court decisions, which, since 1916, have recognized that realistic accrual accounting does "clearly reflect income." If I am correct, the law did not give the Commissioner any "discretion . . . not to accept the taxpayer's accounting system."

367 U. S. at 711-712 (footnotes omitted).

The same voting alignment also occurred in *Schlude* v. *Commissioner*, 372 U. S. 128 (1963).

over the Commissioner's persistent objection for current expenses is not sanctioned for current income.[5]

In light of this chronic problem, the Court should take this case in order to pronounce substantive and procedural guidance for the frequent administrative dictate that an accepted accounting principle give way to the Commissioner's notion of what clearly reflects income. In this regard, there should be at least an obligation upon the Commissioner to justify his preference when it contradicts an accounting methodology widely regarded as designed to accurately report income. To the extent that resolution of this issue involves a re-examination of the implications of *American Automobile Association* and *Schlude*, it is respectfully suggested that there continues to be a serious need to bridge the difference between commercial and tax accounting with intelligible principles upon which business taxpayers can rely.

2. The Commissioner's Disallowance Violates the Substantive and Procedural Intent of the Statute Which Compels a Valuation Method Consistent with Accepted Accounting Practices.

A related but independent reason for this Court's review is that the Commissioner, in disallowing the taxpayer's accounting method which incontestably conformed to sound and generally accepted accounting principles, and the Seventh Circuit in approving his action, violated the intent of the statute and appropriate administrative procedure. Section 471 imposes an obligation on the Commissioner to prescribe a method of accounting conforming as nearly as possible to the "best accounting practice" and which "clearly reflects income." The Commissioner has long

5. Although this case relates to inventories and not current expenses, the pervasive accounting principle of matching period costs with revenues is very much at stake. The cost of making excess replacement parts and of their decline in value, should be recognized in the periods these facts occur or when income is received for the integral products with which they are associated, not some future artificial date.

been urged by interested parties to promulgate a regulation specifically governing the recurring problem of excess inventory. *See Patton, Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, N. Y. U. 23rd INST. FED. TAX. 839, 850 (1965). To the extent that existing regulations fail to do so, it is untenable that the Commissioner may take advantage of his failure and, simply by asserting that it distorts income, reject a method which clearly conforms to sound accounting principles.

The Chamber acknowledges that, to afford an orderly and efficient administration of the revenue laws, Congress has generally granted the Commissioner broad latitude in making determinations in varied contexts, and that such determinations are accorded a presumptive validity. *See, e.g., Helvering* v. *Taylor*, 293 U. S. 507 (1935); *Phillips* v. *Commissioner*, 283 U. S. 589 (1931). Here, however, Section 471 explicitly mandates two concrete standards in the determination—the best accounting practice and the clear reflection of income. In rejecting the taxpayer's method of accounting for inventory, the Commissioner's decision squarely contradicts the standard of best accounting practice.[6] But in doing so, the Commissioner did not necessarily promote the equivalent standard of clearly reflecting income, for there is nothing in this record to substantiate the claim that the accounting principle here distorts income. Moreover, the statute does not exalt one standard over the other but requires a method which, to the extent possible, most nearly satisfies both. Where, as here, the taxpayer's method indisputably satisfies one standard and arguably both, the Commissioner should not be permitted to overreach his discretion by a disallowance which fails to heed the statutory commands. The Commissioner's decision in this case which the Seventh Circuit approved, is indicative more of a reflexive action to

6. The Fifth Circuit in *Space Controls, Inc.* v. *Commissioner*, 322 F. 2d 144, 151 (5th Cir. 1963) (discussed *infra*, at pp. 10-13), correctly held that the best accounting practice is, by statute and regulations, equivalent to generally accepted accounting principles.

protect revenue than a reasoned and principled analysis of the issue.

Although Section 471 has a sparse legislative history, that which there is emphasizes the weight to be accorded the best accounting practice. The phrase "best accounting practice," first appeared in the Revenue Act of 1918, ch. 18, 43 Stat. 1057, 1060 and was inserted by a Senate amendment to the House Bill without significant discussion. When the provision was re-enacted in the Revenue Act of 1921, ch. 136, 42 Stat. 227, 231, however, Senate debate explicitly focused on the meaning of the language. In an exchange of views on the floor, set foth below,[7]

7. Senate consideration of the House Bill was moved by its floor leader, Senator Penrose, who was a member of the Senate Committee on Finance. S. R. No. 275, 67 Cong., 1st Sess. 1 (1921); 61 CONG. REC. (Part 6) 5788 (1921). Senator Penrose responded to an inquiry on the Senate floor as follows:

> MR. KING: Mr. President, may I inquire of the committee . . . whether it is the purpose of this amendment to authorize the commissioner to determine the form of inventory which shall be followed by all business houses in the United States that would be subject to these provisions, regardless of the efficiency and honesty of the methods pursued by business houses in carrying their inventories and ascertaining their liabilities, assets, and so forth?
>
> MR. PENROSE: Mr. President, the provision is existing law, without any alteration, and is now being administered without any great complaint having been called to my attention. *Where the books of a concern are accurate and kept in a businesslike way I am informed that they are accepted by the Treasury Department without question.*
>
> * * * * *
>
> MR. PENROSE: *The law says that the best accounting practice in the trade or business is to be followed. That is all that is necessary.* There is no trouble about this.
>
> MR. KING: Let me say to the Senator that there have been some complaints.
>
> MR. PENROSE: There may be.
>
> MR. KING: Not many have been brought to my attention, but some, that arbitrary requirements have been made by the department with respect to the form of inventories. Certain businesses have established a method of inventorying their business which have met their requirements, and which are regarded

(Footnote continued on next page.)

Congress declared a clear preference for accepted accounting standards as determinative except in instances of patent abuse. In light of the substantial progress in accounting principles since those days, it is captious to dismiss them upon the unelaborated[8] belief that they fail to clearly reflect income.

Without ascribing any definition to the element of clearly reflecting income, the Seventh Circuit nevertheless held that it was a question of fact subject to the clearly erroneous rule and that the Commissioner's "wide discretion" was not to be disturbed unless shown to be arbitrary. (A. 45-46.) That result under Section 471 is unprecedented, however, where the application of that "wide discretion" trammels the statutory element of the best accounting practice without a clue as to how income is thus clearly reflected. Even if the arbitrary standard were applicable to this case, as a matter of law it is nothing less than

(Footnote continued from preceding page.)

> by them and by others as being fair and honest, and a true reflection of the condition of the business; and it has been felt by some that to abandon accepted standards of business, adopted by business men, to conform to the whims and caprices —and I do not use those terms at all offensively—of officials works a very serious hardship.
>
> MR. PENROSE: Mr. President, if the Senator will pardon the expression, let me take absolute issue with him on that point. *The department does not make any arbitrary rules of accounting. The law compels the Internal Revenue Department to compel the taxpayer to follow the best accounting practice. They do not put their arbitrary methods in force. . . .*

61 CONG. REC. (Part 6) 5809 (1921) (emphasis added).

8. The Seventh Circuit here noted that the Tax Court's decision to set aside accepted accounting standards for failing to clearly reflect income was "without elaboration". (A. 41.) Further, the Court of Appeals acknowledged that the regulations, in stating that generally accepted accounting principles will ordinarily reflect income, implies that a method adhering to accounting standards presumptively satisfies the requirement of clearly reflecting income. (A. 44-45.) Yet, the Court of Appeals ruled that because the taxpayer under new management first acted upon the severe problem of excess inventory, its writedown was disqualified as not consistent with the practice of prior management. *Id.* This anomalous reasoning requires a taxpayer to perpetuate past error, even though violating accepted accounting principles with a resultant distortion of its financial picture.

arbitrary to renounce an accepted accounting principle dedicated to financial accuracy, which is all that the statute reasonably demands.

Hence, there exists a serious conflict between the Commissioner's powers as interpreted by the Seventh Circuit and the legislative import of Section 471. In this setting, substantive and procedural standards should be articulated by this Court to assure that the ultimate tax determination follows the mandate of the statute. Where, as here, the taxpayer presents uncontroverted evidence that its method conforms to the best accounting practice, there should be a duty upon the Commissioner to show that the method in fact distorts income or that an alternative method would more nearly adhere to both statutory elements.

3. The Decision of the Court of Appeals Is Inherently Inconsistent with Decisions of the Fifth, Sixth and Tenth Circuits.

Market value tailored to reality has historically been a cardinal tradition for valuation of inventories in our tax framework. *See United States Cartridge Co.* v. *United States,* 284 U. S. 511 (1932). In conflict with decisions in other circuits, the wooden interpretation of the relevant regulations by the Seventh Circuit here gave no credit to the discernible marketplace.

The Fifth and Sixth Circuits have applied the fundamental concept of market value in contexts equivalent to the situation here, where the net realizable value of goods was determined by a realistic appraisal of market conditions. The basic departure of the Seventh Circuit from a practicable application of market value is manifest in contrast with the decision in *Space Controls, Inc.* v. *Commissioner,* 322 F. 2d 144 (5th Cir. 1963). In that case, taxpayer sought to write down inventories of finished goods and work-in-process for custom trailers to the contract sales price which was substantially below cost. The Fifth Circuit rejected the Commissioner's contrary approach

which construed the regulations in a manner that ignored the practical realities of that marketplace. Interpreting a particular example of market value in the regulation, the Fifth Circuit enunciated the following principles which unmistakably conflict with the result reached by the Seventh Circuit:

> To approach it as did the Tax Court, reality would be exchanged for fiction. As to raw materials on hand . . . it reasoned, for example, that there was no evidence that the purchase price on the inventory date for each of the undescribed nuts, bolts, screws, rods, wheels, etc. was less than what had been paid, i.e., the cost. Consequently, it concluded, no comparative was established. But as an economic proposition, it is positively clear that to this Taxpayer such materials if then purchased would not have the value of their cost. Taxpayer's need was confined solely to this specific Government contract. It was obliged to fill that contract. It lacked the freedom which other "purchasers" of such items would have—namely, the right either to recall the items at a markup or use them in a profitable product. Legally bound as it was under its contract, Taxpayer was putting out a dollar to procure an item for which it would get approximately, 70¢. *With its stock on hand dedicated to a contract from which it could not legally escape, it would hardly be a true reflection of the financial condition of that concern were its inventory of dedicated goods valued at an amount which it could never get.* Good accounting practice, good business judgment, and administration of taxes all coincide to demonstrate the wisdom and applicability of . . . [the regulation].

322 F. 2d at 154 (emphasis added).

The same realistic approach to market value was endorsed by the Sixth Circuit in *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N. D. Ohio 1963), *aff'd,* 351 F. 2d 449 (6th Cir. 1965).[9] Although the taxpayers in those cases relied upon other

9. The District Court stated:

> The tax law and generally accepted principles of accounting recognize that substantial accuracy is the objective to be achieved and that in many situations exact determinations are neither practicable nor necessary. Huntington Securities Corporation v. Busey, 112 F. 2d 368 (6th Cir. 1940).

224 F. Supp. at 377.

examples of market values in the regulations, the overriding characteristic of both decisions is the acceptance by those Courts of Appeal of the realities of the market. In contrast, the Seventh Circuit decision is marked by a stringent construction of regulations erroneously regarded as the universe of the market value concept, which denies any space for this taxpayer's method despite its adherence to economic fact.

Each of the reasons espoused by the Seventh Circuit for upholding the Commissioner inflicts great damage to the concept of market value embodied in the regulations and expanded by the policies set forth in the *Space Controls* decision. First, that the facts here do not perfectly mesh with every detail of one or another regulation assumes a rigid construction eschewed by the Fifth Circuit in *Space Controls*.[10] What matters is an accurate assessment of market realities, not inflexible attachment to generalized rules. Second, because the same goods were classified between salable and unsalable, the Seventh Circuit found it impermissible to value differently fungible goods. But that is precisely what the Fifth Circuit found reasonable in *Space Controls*. The constituent nuts and bolts for the custom trailers were not valued according to what the same items would in theory bring on the market, but rather according to the ultimate disposition of those particular units. For separate reasons but with the same economic consequence, the taxpayer here could no more disgorge the excess parts on the market than the taxpayer could the nuts and bolts in *Space Controls*.[11] Finally, the Seventh

10. In addressing one provision of the inventory regulations, the court in *Space Controls* declared:

> The very nature of goods in process and the unidentifiable elements of cost, labor, burden, etc. make it impossible to apply literally § 1.471-4(c). We have recognized that this must be given practical application. S. G. Sample Co. v. Commissioner, 5 Cir. 1928, 23 F.2d 671 cited in 2 Mertens, Federal Income Taxation, § 16.21, n. 67, p. 46 (1961).

322 F. 2d at 154, n. 22

11. Further, the use of formulations tied to experience in computing taxable income is not unique to excess inventories. For

(Footnote continued on next page.)

Circuit imposed the harsh barrier of a closed transaction which conditions the writedown upon the physical disposition as scrap. Again, practical considerations are sacrificed to generalized rules. Moreover, the Fifth Circuit in *Space Controls*, relying upon a Tax Court decision, held that a trip to the junkyard was not a prerequisite to realizing scrap value:

> "When it became apparent that the going market value of a particular machine was less than (taxpayer's) cost basis, the inventory valuation was reduced to accord with market. . . . This procedure properly resulted in the realization of a loss when it occurred—the year the machine became worthless, not necessarily the year the machine was physically cast upon the scrap pile. C-O-Two Fire Equipment Co. v. Commissioner, 3 Cir., 1955, 219 F.2d 57."

Space Controls, Inc. v. *Commissioner*, 322 F. 2d at 152-153, *quoting from Ernest, Holedman & Collett, Inc.*, 1960 Tax Ct. Mem. Dec. (P-H) ¶ 60,010 at p. 54, *aff'd*, 290 F. 2d 3 (7th Cir. 1961).

The inflexible approach of the Seventh Circuit is also at odds with the recent decision of the Tenth Circuit in *Monfort of Colorado, Inc.* v. *United States*, 561 F. 2d 190 (10th Cir. 1977), where a taxpayer was allowed to include gains and losses from commodity hedging as an inventory cost. In contrast to the reasoning of the Seventh Circuit here, the Tenth Circuit ruled that taxpayer's method was "in keeping with the regulatory mandates that valuations of inventory must necessarily be flexible in order to give effect to trade customs . . ." 561 F. 2d at 196. More important, the Court also found it decisive that the regula-

(Footnote continued from preceding page.)

example, in arriving at the portion of account receivables representing bad debts, a business uses gross categories of aging as a reasonable estimate. It would be absurd to conclude that there are no worthless accounts in a group of "fungible" receivables simply because a taxpayer cannot select this or that particular receivable which will in fact default. Yet the burden of selecting, from multiple quantities of over 44,000 different replacement parts, those that were in fact worthless was unreasonably imposed upon the taxpayer in this case.

tions did not *prohibit* the method, rather than hanging the issue on what the regulations permitted:

> We deem it significant to note that the IRS expert acknowledged that there was nothing in the regulations, to the best of his knowledge, which prohibited Monfort's tax treatment of hedging gains/losses. Under the circumstances, we will not hold that there is but one way and one way only for Monfort to value its ending inventories.

Id.

In essence the decision of the Seventh Circuit is based on a slavish and unrealistic construction of the statute and regulations which distorts both the concept of market value and, consequently, taxable income. That approach collides with the policy of a practical, sensible analysis fostered by the Fifth, Sixth and Tenth Circuits which strives for reality, not fiction. Because this issue has widespread implications to the business economy and to the revenue laws, this Court should reconcile this palpable disparity which, left unresolved, promises to be a source of continuing confusion.

4. The Procedure Utilized by Taxpayer Was a Realistic Application of Market Value Authorized by Applicable Regulations.

The inventory regulations promulgated by the Commissioner explicitly approve the accepted accounting rule of lower of cost or market. Treas Reg. § 1.471-2(c) (1958). They also define examples of unusual market conditions which necessitate unique valuation procedures. The taxpayer here relied upon two separate definitions of exceptional market conditions to measure its inventory value. First, where no open market exists, a taxpayer is permitted to "use such evidence of a fair market price . . . as may be available." Treas. Reg. § 1.471-4(b) (1958). Second, in a comparable situation, yet another regulation accommodates market determinations for goods "unsalable at normal prices" in the case of such factors as "changes of style,

odd or broken lots or other similar causes." Treas. Reg. § 1.471-2(c) (1958). The Tax Court made findings which essentially equated these excessive replacement parts to "unsalable goods" and to goods for which an open market was lacking.[12] Nonetheless both the Tax Court and ultimately the Seventh Circuit held both regulations inapplicable by construing them impracticably and erroneously. More important, in concentrating upon minutiae in the regulations, the decision of the Seventh Circuit completely lost sight of the fact that taxpayer's method was a rational and empirical appraisal of market realities, the very objective both regulations encourage.

In providing for the lack of an open market, Regulation § 1.471-4(b) recognizes that supply and demand are prominent in the market value equation. If the quantity is too large to be absorbed by the available market, even with demand stimulated by price reductions, there is no "open" market. By definition, there simply was no market for the portion of the inventory here reasonably concluded upon past experience to be unsalable in any event. It was precisely for this reason that the taxpayer

---

12. The Tax Court found that:

> [E]xcess parts . . . comprised in each year from 70 percent to 82 percent of the excess inventory costs. *The market for such parts was confined to owners of the related tools who purchased replacement parts when and if needed and would not buy parts not needed merely because of price reductions.*
>
> Petitioner reduced prices on some finished tools where management believed that price reductions would stimulate sufficient additional sales to increase its gross income. Most of the finished tools in excess supply, however, were specialized products, and petitioner's management concluded that *their potential market was so limited that a price reduction would not stimulate additional sales to increase gross receipts above what they would be if the salable quantities were sold at current prices. . . .*
>
> Petitioner's management concluded that *the only secondary market for excess work-in-process* (consisting of partially completed parts or tools) *was as scrap. Petitioner attempted to sell excess raw materials in 1964, but these efforts met with very little success because users of such hardware items as nuts, bolts, screws and washers, prefer to purchase them from an established supplier. . . .*
>
> (A. 14; emphasis added.)

was compelled to writedown the inventory for the purposes of financial accounting and securities regulation. In accordance with Regulation § 1.471-4(b), market value was thus computed with the best available evidence, management experience fortified by the unchallenged testimony of highly qualified professionals. In the face of this, the Commissioner introduced no evidence whatever.

The Seventh Circuit held Regulation § 1.471-4(b) inapplicable on the grounds that excess inventory is a common problem and therefore not an "extraordinary circumstance." This is an obvious misreading of the regulation. It and other regulations are concerned with the efficiency of the market conditions and the validity of the market price, not the frequency with which the problem occurs. The "normal conditions" referred to are such situations as an active market, arms length transactions, sufficient depth to absorb the quantity of goods involved, and responsiveness to the normal laws of supply and demand. Since these conditions were demonstrably absent here, there was no open market for the goods in the quantity involved. The regulations specifically recognize this lack of an open market as an untypical circumstance justifying special valuation procedures.

With respect to Regulation § 1.471-2(c), even though the inventory items were "unsalable at normal prices," the Seventh Circuit nevertheless held that excess inventory could not be equated to "changes of style, odd or broken lots, or other similar causes." In particular, it was held that the unsalability here was not attributable to any "other similar cause" since all enumerated causes consisted of defective goods distinct from the remaining inventory, while excess inventory was indistinguishable from the salable portion of the inventory.

This reasoning reflects a unreasonable construction of Regulation § 1.471-2(c) which conflicts with its overriding purpose. Two of the specified causes, "changes of style" and "odd or broken lots," in fact assign different values between physically

fungible goods in recognition of market dynamics. Odd lots may be valued lower, not because of a physical distinction, but in view of their unsuitability in the established market. Further, all the excess inventory was economically equivalent to an odd lot, inasmuch as it constituted an abnormal quantity unfit for market conditions.[13]

In short, the language of both regulations are readily adaptable to excess inventory, especially if read in light of their purpose of attaining a realistic application of market value.

CONCLUSION

The economic scope of the issues in this case is extraordinary both as to the extent of prospective litigation and the amount of income taxes involved. Equally at stake is the choice of a creditable policy that recognizes the validity of reliable accounting rules consistent with the statutory framework, in place of one that uncritically acquiesces in administrative action that bears no identifiable standards. It is within the distinctive province

13. Regulation § 1.471-2(c) states that with respect to the enumerated causes, the abnormality in the market is to be measured by an actual offering of the goods within 30 days after the inventory closing. Literal application of that requirement would serve no purpose here. The Tax Court found that taxpayer did offer goods at reduced prices when gross receipts would not decrease. Taxpayer cannot be made to suffer an additional loss simply to establish its loss in a prior year. *See C-O-Two Fire Equipment Co.* v. *Commissioner*, 219 F. 2d 57 (3d Cir. 1955).

of this Court to review the unsettling and unfair result in this case which adversely affects so many taxpayers.

For the foregoing reasons, this Court should grant the petition for writ of certiorari.

Respectfully submitted,

ALLAN B. MUCHIN
FRANCIS X. GROSSI, JR.
ROBERT S. CONNORS
KATTEN, MUCHIN, GITLES, ZAVIS
PEARL & GALLER
4100 Mid-Continental Plaza
55 East Monroe Street
Chicago, Illinois 60603
(312) 346-7400
Counsel for Amicus Curiae Chamber of Commerce of the United States

Of Counsel:
LAWRENCE B. KRAUS
General Counsel
Chamber of Commerce of the
United States of America
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6036

STANLEY T. KALECZYC, JR.
Director of Litigation
National Chamber Litigation Center
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6218

No. 77-920

In the

Supreme Court of the United States

October Term, 1977

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS OF THE UNITED STATES OF AMERICA, AS AMICUS CURIAE IN SUPPORT OF PETITION

Crane C. Hauser
Arthur I. Gould
One First National Plaza
Suite 5000
Chicago, Illinois 60603
312-786-5600

Richard D. Godown
General Counsel

John Lucas
Associate General Counsel
National Association of Manufacturers
1776 F Street, N.W.
Washington, D.C. 20006
202-331-3700

Attorneys for the National Association of Manufacturers of the United States of America, *Amicus Curiae*

Of Counsel:
Winston & Strawn

The Scheffer Press, Inc.—(312) 263-6850

INDEX

List Of Authorities

Statutes

Treasury Regulations

I.R.S. Ruling

Miscellaneous

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

---

BRIEF OF THE NATIONAL ASSOCIATION OF MANUFACTURERS OF THE UNITED STATES OF AMERICA, AS AMICUS CURIAE IN SUPPORT OF PETITION

The National Association of Manufacturers of the United States of America ("NAM"), as *Amicus Curiae* pursuant to consent of the parties under Rule 42 of this Court, respectfully supports the petition of Thor Power Tool Co., praying that a Writ of Certiorari issue to the United States Court of Appeals to review its judgment in *Thor Power Tool Co.* v. *Commissioner of Internal Revenue,* 563 F.2d 861 (1977). The issue in that decision to

which this brief is directed is not a technical tax issue affecting a minor segment of the tax population, but is an issue of national importance involving a great number of dollars. This brief will not rehash the arguments ably made by the Petitioner in its brief; its purpose is to highlight the significance of the issue and to point out some critical errors and deficiencies in the decision of the court below. The issue is whether the Commissioner of Internal Revenue ("the Commissioner"), under Section 471 of the Internal Revenue Code of 1954 ("the Code"), has the discretion to disallow for income tax purposes write-downs of excess inventories to realizable values when such write-downs are required for financial reporting purposes under generally accepted accounting principles.

INTEREST OF THE NAM

The NAM, a New York corporation not for profit, is an organization exempt from Federal income taxation under Code §501(c)(6) as a business league. It is a trade association which represents the common business interests of more than 13,000 manufacturing corporations.

A very substantial number of the members of the NAM value their inventories under the valuation method known as "cost or market, whichever is lower," which method is specifically authorized under Treas. Regs. §1.471-4, and have for many years written down the values of their inventories to reflect the presence of "excess inventories," i.e., inventories held in quantities exceeding those which can be sold, as required to comply with generally accepted accounting principles.

These write-downs of inventories, which are required in order to obtain a profit and loss statement certified by a

certified public accountant, and thus also required by the Securities and Exchange Commission under Section 19(a) of the Securities Act of 1933,[1] have been for many years allowed by the Internal Revenue Service in the computation of taxable income.

Should the Seventh Circuit's decision in the *Thor* case, which the Internal Revenue Service regards as applicable to all taxpayers, not be reversed by this Court, these members of the NAM, as well as countless other taxpayers engaged in non-manufacturing activities, will be adversely and substantially affected.

The imposition of extensive retroactive tax liabilities upon income which will never be realized will result either in heavy financing costs or in uneconomical scrapping of inventories, either of which will cause substantial and unnecessary price increases.

[1] Thor's failure in prior years to write down its excess and obsolete inventories resulted in the filing of three lawsuits against Thor and its former independent accountants (*Sweeney* v. *Thor Power Tool Co., Stewart Warner Corp., et al.,* Circuit Court of Cook County, Illinois, No. 65 CH 1971; *Drake* v. *Thor Power Tool Co., Stewart Warner Corp., et al.,* U.S. District Court, N. Dist. Ill., E. Div., No. 65 C 1133; and *Greenwald* v. *Thor Power Tool Co., Stewart Warner Corp., et al.,* District Court, N. Dist. Ill., E. Div., No. 65 C 1928), a lawsuit by Thor against its former management (*Thor Power Tool Co.* v. *Hurley,* Circuit Court of Cook County, Illinois, No. 65 C 2973), and an investigation by the Securities and Exchange Commission.

ARGUMENT

I.

This is not a technical tax issue involving a small number of taxpayers. It is an issue of national importance. The Internal Revenue Service has informed counsel for NAM that there are presently 371 cases docketed in the United States Tax Court, in which this issue is the principal issue, involving $25,266,992 of tax deficiencies, and that there are 493 cases pending in the Appellate Division of the Internal Revenue Service, involving an unknown dollar amount of deficiencies asserted and refunds claimed. While no figures have been furnished with respect to cases pending in the Audit Division of the Internal Revenue Service, it is no exaggeration to state that the Audit Division, whose caseload is many times that of the Appellate Division, must have pending cases on this issue involving at least $100,000,000 of deficiencies, and probably more.[2] Given the limited audit capacity of the Service, these pending cases, substantial as they are, probably represent only the "tip of the iceberg."

In any event, the fact that five expert witnesses from four of the largest firms of certified public accountants testified in this case that such inventory write-downs were required under generally accepted accounting principles and that the failure to make such write-downs would preclude the certification of financial statements, adequately demonstrates that this issue is one of major significance to the national business community.

[2] Most cases involving this issue have been suspended in the Audit Division for many years, awaiting the ultimate outcome of the *Thor* case.

II.

Moreover, entirely apart from the major and adverse economic effects of the *Thor* decision on this issue, a question of grave importance in tax administration is presented: If, as the Court of Appeals for the Seventh Circuit held, the Commission has unbridled discretion under Code §471 to disallow an inventory valuation method which is required by generally accepted accounting principles, by simply asserting that such method does not clearly reflect income for tax purposes, has not the requirement of Code §471 that the method must conform to the ''best accounting practice in the trade or business'' been written out of the statute?

The pathway to this decision commences with a statement that Code §471 contains a "two-part standard" on which the Commissioner must act regarding inventory methods ("best accounting practice in the trade or business" and "most clearly reflecting the income"), as opposed to the single standard presented in Code §446 dealing with accounting methods in general (''clearly reflect income''). From this statement, the peculiar conclusion is drawn that this means the Commissioner's discretion is greater with respect to inventory methods than it is with respect to accounting methods in general (A-39).[3] Having so concluded, the court below then stated, on the authority of a group of factually irrelevant cases, that the Commissioner's determination that an inventory method reflecting the "best accounting practice" does not clearly reflect taxable income must be upheld unless "plainly arbitrary" (A-40).

Next, the court below held that the inventory method in issue was not sanctioned by specific regulations (A-42-44), that the provision in the Treasury Regulations that an inventory method conforming to the "best accounting prac-

[3] The references are to the Appendix to Thor's petition for *Certiorari*.

tice" in a business ordinarily results in a clear reflection of income was nullified by a lack of consistency in the application of the method (A-44-45), and that the Commissioner's determination was not an abuse of discretion, because Thor had no one testify that its method clearly reflected *taxable income* (A-45-46)—the issue the court was supposed to decide.

Finally, the court observed that it was not an abuse of discretion for the Commissioner to require that excess inventories be scrapped before their losses in value may be reflected in taxable income, under the theory that since the "lower-of-cost-or-market" method of inventory valuation is an exception to the general rule in taxation of requiring "closed transactions" or "identifiable events" for the realization of losses, the Commissioner is free to qualify the use of that method in any way he chooses (A-46-47).

Rather than rehash the arguments ably presented by the Petitioner in its brief, the NAM merely wishes to point out a few critical errors in the decision of the court below.

It should be self-evident that since Code §471 contains two standards governing the discretion of the Commissioner, and since Code §446 contains only one, the discretion of the Commissioner is more restricted under Code §471 than it is under Code §446, and that the cases cited by the court below in support of its conclusion that the Commissioner's action could not be set aside unless "plainly arbitrary," which arose principally under Code §446, are not controlling.[4]

[4] Additionally, as the Petition points out on page 19, none of the cited cases involved accounting methods which were in accordance with generally accepted accounting principles.

The court below, as well as the Tax Court, misinterpreted the "two-part standard" of Code §471, leading it to conclude that the "best accounting practice" standard was within the province of the accounting profession, while the "clearly reflecting the income" standard was within the uncontrolled discretion of the Commissioner. While there may have been, at the time the Revenue Act of 1918 initiated the language of Code §471, some divergencies between the best accounting practices in some businesses and the clear reflection of income, the development in the meantime by the accounting profession of generally accepted accounting principles, and the shift of emphasis, under those principles, from reasonableness and accuracy of balance sheet presentation to reasonableness and accuracy of the income statement, mean that, as recognized by the Treasury Regulations,[5] an inventory method which is in accordance with generally accepted accounting principles will ordinarily result in a clear reflection of income. They mean, in short, that the Commissioner's discretion in this area is, in fact, exceedingly narrow.

The court below held that the regulatory presumption that an inventory method in accordance with generally accepted accounting principles would clearly reflect income

[5] The Internal Revenue Service, in commenting upon proposed changes in the regulations under Code §446, stated, in I.R.S. News Release No. 1186, December 15, 1971, 727 CCH Standard Federal Tax Reporter ¶6291: "Also the terminology 'generally recognized and accepted income tax accounting principles' is changed to 'generally accepted accounting principles' to emphasize that the Internal Revenue Service will, whenever possible, consistent with the requirement that methods of accounting for tax purposes 'clearly reflect income' and be in accordance with other provisions of the Internal Revenue Code, follow principles adopted by the accounting profession in accounting for inventories."

was "dissipated" by an "inference" in the Tax Court opinion that Thor had been inconsistent in the use of this method. Entirely apart from the questionable nature of a conclusion based upon an untried issue, it is clear that the Commissioner's disallowance of the inventory method used by Thor was not based upon lack of consistency. Twelve days after the date of the decision in the court below, Revenue Ruling 77-364, I.R.B. 1977-41, p. 9, was issued, holding that a percentage write-down of excess inventories was not an acceptable method of inventory valuation, in a factual situation where the taxpayer consistently used such method. Obviously, the court below was misled as to the basis for the Commissioner's determination.[6]

As noted above, the final argument constructed by the court below was that the Commissioner was free to accept, in a limited manner, "the lower-of-cost-or-market" method of inventory valuation, by requiring, in the case of excess inventories, that they be valued at cost until scrapped. In essence, this finding means that the Commissioner is free to disregard "the best accounting practice in the trade or business," which is to value excess inventories at realizable value.

In other words, the court below held that the Commissioner, by virtue of his long-standing failure to provide in the regulations for the specific treatment of excess inventories under the "lower-of-cost-or-market" method of inventory valuation, was free to disregard the statute.

---

[6] Indeed, the Commissioner's notice of deficiency determined that the write-down of excess inventories was disallowed as not qualifying as a business expense under Code §162 (A-17). The thought of invoking Code §471 did not occur until shortly before the case was tried in the Tax Court.

He need not state why an inventory method which clearly reflects financial income fails to clearly reflect taxable income; he needs only to remain silent. He need not demonstrate why a valuation at cost until scrapping will most clearly reflect income; he needs only to say that the method which is in accordance with generally accepted accounting principles is unacceptable to him.

Once the "best accounting practice" stricture has been removed—and this stricture was deliberately added by Congress[7]—the same result is observed in the inventory area as has occurred in other areas of broad administrative discretion. The method of valuation which "clearly" reflects income has been held by the Commissioner to be whatever method "early" reflects the income.

---

[7] The phrase was added to the House version of Section 203 of the Revenue Act of 1918 by the Senate, and adopted in conference. H.Rep. No. 1037, 65th Cong., 3rd Sess., p. 45, 1939-1 C.B. (Part 2) 132.

CONCLUSION

The judgment of the court below, which, contrary to Code §471, confers a broad discretion upon the Commissioner to disregard generally accepted accounting principles of inventory valuation, is not only incorrect, but an unconscionable retroactive financial burden for American business. The NAM urges that a writ of *certiorari* issue to review this judgment.

Respectfully submitted,

Crane C. Hauser
Arthur I. Gould
One First National Plaza
Suite 5000
Chicago, Illinois 60603
312-786-5600

Richard D. Godown
General Counsel

John Lucas
Associate General Counsel
National Association of Manufacturers
1776 F Street, N.W.
Washington, D.C. 20006
202-331-3700

Attorneys for the National Association of Manufacturers of the United States of America, *Amicus Curiae*

Of Counsel:
Winston & Strawn

CERTIFICATE OF SERVICE

I hereby certify that on February 3, 1978, I served three copies of this Brief for the National Association of Manufacturers of the United States of America, as *Amicus Curiae*, in support of the Petition for a Writ of *Certiorari* by Thor Power Tool Co., upon each of the parties to this proceeding by depositing the same, enclosed in a sealed envelope with first class postage thereon fully prepaid, in a United States mail box at Chicago, Illinois, addressed to the attorneys for the parties as follows:

Mark H. Berens
Lee N. Abrams
John E. Allen
Douglas A. Poe
Suite 1955
231 South LaSalle Street
Chicago, Illinois 60604

Honorable Wade Hampton McCree, Jr.
Solicitor General of the United States
U.S. Department of Justice
Washington, D.C. 20530

....

Arthur I. Gould
Attorney for the National Association of Manufacturers of the United States of America.

APPENDIX

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Petition for Certiorari filed December 27, 1977.
Certiorari Granted March 6, 1978.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

TABLE OF CONTENTS

DATES OF RELEVANT PROCEEDINGS IN LOWER COURTS

1. Statutory Notice of Deficiency by Commissioner of Internal Revenue ("Respondent") to Thor Power Tool Co. ("Petitioner"), dated June 20, 1969
2. Petition to Tax Court of United States by Petitioner, filed September 22, 1969
3. Answer by Respondent, filed November 18, 1969
4. Motion by Petitioner for orders (i) establishing burden of proof on new issue raised by Respondent and (ii) to keep record open after trial for proof of year in which inventory became excess, filed May 25, 1972
5. Memorandum of Law by Petitioner in support of Motion of May 25, filed June 13, 1972
6. Proceedings before the Tax Court on Motion of May 25, held June 14, 1972 (transcript of 50 pages)
7. Order granting both parts of Petitioner's Motion of May 25, entered June 14, 1972
8. Motion by Respondent for leave to amend Answer, filed June 22, 1972
9. Memorandum by Petitioner on Respondent's Motion for leave to amend Answer, filed June 22, 1972
10. Order permitting amendment to Answer, entered June 22, 1972
11. Amendment to Answer, filed June 22, 1972
12. Reply by Petitioner to Amendment to Answer, filed June 22, 1972
13. Stipulation of Facts, filed June 22, 1972

14. Stipulation on Issues, filed June 22, 1972
15. Trial before the Tax Court held on June 22, 23 and 26, 1972 (Transcript of 388 pages)
16. Findings of Fact and Opinion of Tax Court, entered May 6, 1975
17. Respondent's Computation of Tax for Entry of Decision under Rule 155, filed September 22, 1975
18. Petitioner's Motion for leave to amend Petition, filed October 22, 1975
19. Order permitting Petitioner to amend Petition, granted October 29, 1975
20. Amendment to Petition, filed October 29, 1975
21. Respondent's Answer to Amendment to Petition, filed November 24, 1975
22. Agreed Computation under Rule 155, filed January 7, 1976
23. Decision of Tax Court, entered January 12, 1976
24. Notice of Appeal by Petitioner to the United States Court of Appeals for the Seventh Circuit, filed April 12, 1976
25. Oral argument before the Court of Appeals for the Seventh Circuit, held on December 7, 1976
26. Opinion and Order of the Court of Appeals for the Seventh Circuit affirming decision of Tax Court, entered September 29, 1977
27. Petition for Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit, filed December 27, 1977
28. Petition for Writ of Certiorari granted March 6, 1978

STATUTORY NOTICE OF DEFICIENCY

[Excerpts]

[June 20, 1969]

* * *

(b) The deduction of $136,150.36 for bad debts under reserve method is disallowed to the extent of $74,790.80 because it has not been established that any amount in excess of $61,359.56 constitutes a reasonable addition to the reserve under section 166 of the Internal Revenue Code of 1954.

* * *

EXHIBIT A

Computation of Net Operating Loss

TAXABLE YEAR ENDED DECEMBER 31, 1962

Adjustments to Income

Taxable loss disclosed by return		($5,185,160.83)
Additional income and unallowable deductions:		
(a) Inventory reserve	$1,079,069.00	
(b) Dividend	128,837.00	1,207,906.00
Taxable loss adjusted		($3,977,254.83)

Explanation of Adjustments

(a) The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954.

* * *

TAX COURT OF THE UNITED STATES

THOR POWER TOOL COMPANY, *Petitioner*, *vs.* COMMISSIONER OF INTERNAL REVENUE, *Respondent*.	Docket No. 4795-69

PETITION

[Filed 9-18-69]

The above-named Petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (bearing symbols A:R:SN) dated June 20, 1969, and, as the basis for its case, alleges as follows:

1. Petitioner is a Delaware corporation and has, and at all times relevant hereto has had, its principal place of business and its principal office at 175 North State Street, Aurora, Illinois 60507. The returns for the periods involved herein were filed with the office of the District Director of Internal Revenue at Chicago, Illinois.

2. The notice of deficiency and the statement referred to therein (copies of which are attached hereto and collectively marked Exhibit A) were mailed to Petitioner on June 20, 1969.

3. The Commissioner determined a deficiency in income tax for the calendar year 1963 in the amount of $545,977.64, of which approximately $491,951.00 is in controversy, and for the calendar year 1965 in the amount of $59,701.35, of which approximately $58,927.00 is in controversy.

4. The determination of tax set forth in said notice of deficiency is based upon the following errors:

(a) The Commissioner erred in determining the taxable income of Petitioner for the calendar year 1963 by "grossing up" as dividend income to Petitioner, under I. R. C. § 78, $161,927.00 of foreign taxes which the Commissioner alleges were deemed paid under I. R. C. § 902 by Petitioner as a result of dividends received in 1963 from Thor Power Tool Company, Limited ("Limited"), its wholly-owned English subsidiary.

(b) The Commissioner, in determining the taxable income of Petitioner for the calendar year 1963, erred in computing the net operating loss deduction available under I. R. C. § 172 as a carryback from a net operating loss incurred by Petitioner in 1964 by treating as 1964 dividend income to Petitioner, under I. R. C. § 78, $128,837.00 of foreign taxes which the Commissioner alleges were deemed paid by Petitioner under I. R. C. § 902 as a result of dividends received in 1964 from Limited. The Commissioner should have treated as 1964 dividend income to Petitioner no more than $83,344.00, which is the amount of tax deemed paid by Petitioner on its subsidiaries' accumulated profits attributable to 1963.

(c) The Commissioner, in determining the taxable income of Petitioner for the calendar year 1963, erred in computing the net operating loss deduction available under I. R. C. § 172 as a carryback from a net operating loss incurred by Petitioner in 1964 by disallowing for that year $1,079,069.00 of the $22,279,949.71 claimed by Petitioner as its cost of goods sold for that year. The Commissioner's adjustment included in closing inventory on December 31, 1964, $1,079,069.00 of unsalable goods which were

obsolete or excess, and which Petitioner had excluded from such inventory. The Commissioner also erred in requiring that Petitioner's claim for cost of goods sold in 1964 must be established as an "allowable deduction" under I. R. C. § 162 or other deduction section of the Code.

(d) The Commissioner erred in determining the taxable income of Petitioner for the calendar year 1965 by disallowing as a deduction, under I. R. C. § 166, $74,790.80 of the total $136,150.36 Petitioner had added to its reserve for bad debts.*

(e) The Commissioner erred in calculating (in Exhibits E and F of the notice of deficiency) the credits for foreign income taxes available to Petitioner in 1963 and 1965. This error is based in part on his failure to recognize that Petitioner claimed the global election in each of the years covered by Exhibits D and E, and in part on his failure to include Petitioner's 1963 taxable income from Canada in determining the overall foreign tax credit limitation for that year under I. R. C. § 904. Insufficient information has been supplied by the Commissioner to determine what other errors, if any, may have been made in his foreign tax credit calculation.

5. The facts upon which Petitioner, who at all times relevant hereto prepared and filed its income tax return on a calendar year basis and used the accrual method of accounting, rely as the bases of this case are as follows:

(a) All of the dividends paid by Limited to Petitioner in 1963 were paid from profits accumulated in 1962 or earlier years by Limited or by Limited's

* Petitioner does not contest the Commissioner's disallowance of a claimed deduction of $1,627.00 for organization expenses, and Petitioner agrees to pay the tax resulting therefrom together with any interest due thereon.

wholly-owned subsidiaries, Thor Tools, Ltd. ("Tools") and Thor Power Tool, GmbH ("GmbH"). Under I. R. C. § 78 foreign taxes deemed paid by Petitioner with respect to such dividends are not required to be included in Petitioner's income for 1963.

(b) None of the dividends paid by Limited to Petitioner in 1964 were paid from profits accumulated in 1964 by Limited, Tools or GmbH. Of these 1964 dividends, at least $130,893.00 were paid from profits accumulated in 1962 or earlier years by Limited or by its subsidiaries, Tools and GmbH. Under I. R. C. § 78, foreign taxes deemed paid by Petitioner with respect to that portion of 1964 dividends paid out of profits accumulated in 1962 or earlier years are not required to be included in Petitioner's income for 1964.

(c) Petitioner at all times relevant hereto valued its inventory on the basis of the lower of cost or market. As part of closing its books and preparing its annual financial reports and its income tax return for calendar year 1964, Petitioner's management ordered a detailed analysis of its existing inventory to assure that it would accurately reflect its value on the basis of sound accounting principles. This analysis revealed that quantities of certain items in the inventory were unsalable because they were obsolete or in excess of the foreseeable market demand for such items, and it was further determined that their direct cost of disposal was equal to or exceeded their potential disposal price. This reduction in closing inventory included the following:

(i) Based on their then knowledge of the power tool industry in general and Petitioner's product lines in particular, including the rate of

technological innovation, resulting obsolescence and Petitioner's most recent sales and usage, Petitioner's management determined the following portions of such inventory items to be unsalable as obsolete or excess:

Number of Months' Supply—Based on 1964 Sales/Usage	Incremental Percent of Inventory Determined to Be Unsalable
1-12	0%
13-18	50% over 12 mos.
19-24	75% over 18 "
over 24	100% over 24 "

This adjustment amounted to $918,862.00

(ii) An additional adjustment of $160,210.00 was made in the value of certain categories of inventory where management believed that the adjustment described in subparagraph 5(c)(i) was not accurate or not applicable.

The determination of the quantities of inventory items which were unsalable as obsolete or excess was made after a careful analysis by Petitioner's management, was based on extensive experience, and is consistent with I. R. C. § 471 which requires that inventories be valued on a basis "conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income" of the taxpayer, and in particular with *Treas. Reg.* § 1.471-2(c) which provides in relevant part:

> "Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, . . . should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) [cost] or (2) [lower of cost or market] of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value."

(d) Petitioner at all times relevant hereto has accounted for bad debts on the reserve method. In late 1965, an analysis of Petitioner's accounts receivable was undertaken in order to determine the amount of reserve reasonably required to offset expected losses on such accounts. All inter-company accounts with related companies were deemed to be fully collectible, and no reserve was taken against them. All unrelated customer accounts of over $100 which were more than 90 days past due were considered individually, on the basis of currently available credit information and experience with each debtor. A portion of these accounts were specifically deemed to be wholly uncollectible, and a 100% reserve was taken against them. A similar ratio was applied to customer accounts with balances of less than $100 which were more than 90 days past due. Finally, the remaining accounts were aged and a reserve of 1% was taken against those accounts which were current and a reserve of 2% against those which were then past due. This analysis revealed that not less than $228,947.00 of Petitioner's accounts receivable would be uncollectible, requiring an addition to the reserve for bad debts in the amount of $136,150.36. The Commissioner, however, has disallowed $74,790.80 of this addition to the reserve for bad debts, apparently on the basis that the historical bad debt experience of Petitioner was the sole factor to be relied upon in determining the reasonableness of Petitioner's reserve, ignoring the detailed analysis conducted by Petitioner.

(e) Petitioner at all times relevant hereto has calculated its foreign tax credit limitation on the basis of the overall limitation, provided for in I. R. C. § 904(a)(2). Petitioner's taxable income from Canadian sources in 1963 was $113,343.00 (rather than $136,945.00, as previously reported by Petitioner). The Commissioner failed or refused to take these facts into account in calculating Petitioner's foreign tax credit limitation for 1963 and 1965. Because the Commissioner's notice of deficiency contains insufficient information, it is impossible to determine whether or not additional relevant facts have been ignored.

WHEREFORE, Petitioner prays that this Court may hear this case, determine that the Commissioner erred as alleged in the assignments or error as set forth in paragraph 4 above, determine that there is no deficiency in income tax for the calendar years 1963 and 1965 (except such income tax as may be due as a result of the agreed upon disallowance in 1965 of a deduction for organization expenses in the amount of $1,627.00, the inclusion in Petitioner's 1964 income under I. R. C. § 78 of $83,344.00, and the decrease in Petitioner's 1963 taxable income from Canadian sources by $23,602.00) and grant such other and further relief as this Court may determine to be just and appropriate.

/s/ MARK H. BERENS
Mark H. Berens
231 South LaSalle Street
Chicago, Illinois 60604

/s/ STANTON A. KESSLER
Stanton A. Kessler
231 South LaSalle Street
Chicago, Illinois 60604

/s/ JOHN E. ALLEN
John E. Allen
231 South LaSalle Street
Chicago, Illinois 60604

Of Counsel:
MAYER, FRIEDLICH, SPIESS,
TIERNEY, BROWN & PLATT
231 South LaSalle Street
Chicago, Illinois 60604
STate 2-0600

[Caption Omitted]

ANSWER

[Filed Nov. 18, 1969]

The Respondent, in answer to the petition filed in the above-entitled case, admits and denies as follows:

1. Admits that petitioner is a corporation with its principal office and place of business at 175 North State Street, Aurora, Illinois 60507, and that the returns for the periods involved herein were filed with the office of the District Director of Internal Revenue at Chicago, Illinois. Denies the remaining allegations of paragraph 1. of the petition.

2. Admits the allegations of paragraph 2. of the petition.

3. Admits that the Commissioner determined a deficiency in income tax for the calendar year 1963 in the amount of $545,977.64, and for the calendar year 1965 in the amount of $59,701.35. Denies the remaining allegations of paragraph 3. of the petition.

4.(a) through (e) Denies that the Commissioner erred as alleged in subparagraphs (a) through (e) of paragraph 4. of the petition.

5.(a) through (c)(ii) Denies the allegations of subparagraphs (a) through (c)(ii) of paragraph 5. of the petition.

(d) Admits that petitioner at all times relevant hereto has accounted for bad debts on the reserve method. Denies the remaining allegations of subparagraph (d) of paragraph 5. of the petition.

(e) Denies the allegations of subparagraph (e) of paragraph 5. of the petition.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified, or denied.

Wherefore, it is prayed that the deficiencies determined by the respondent be in all respects approved.

/s/ K. Martin Worthy (GTD)
K. Martin Worthy
Chief Counsel, Internal Revenue Service

Of Counsel:
Frank C. Conley
Regional Counsel
Seymour I. Sherman
Attorney
Internal Revenue Service
Room 1622—35 East Wacker Drive
Chicago, Illinois 60601

[Caption Omitted]

MOTION FOR ORDER (i) ESTABLISHING BURDEN OF PROOF ON NEW ISSUE AND (ii) TO KEEP RECORD OPEN AFTER TRIAL FOR PROOF OF YEAR IN WHICH INVENTORY BECAME EXCESS

[Filed May 25, 1972]

The Petitioner Moves, pursuant to the provisions of Rules 19 and 32 of the Rules of Practice of the United States Tax Court, that the Court issue an order: (i) that the burden of proof shall be on the Respondent if Respondent puts in issue whether the Petitioner changed its method of accounting without permission, as required by I. R. C. § 446(e), for the year 1964; and (ii) that the record in this case shall remain open after the trial and for a reasonable period after the decision herein for the purpose of receiving evidence concerning the year or years in which items of inventory became excess and unsaleable, if by virtue of the Court's decision such evidence is relevant to a determination of Petitioner's tax liability.

In Support of Its Motions, Petitioner states the following:

1(a) The Statutory Notice of Deficiency ("SND") issued by Respondent on June 20, 1969, which is designed to inform Petitioner concerning the amount of tax at issue and the reasons why Respondent contends that that amount is at issue, contained the following explanation concerning the 1964 closing inventory issue in this proceeding:

> "The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954."

(b) In the Petition filed herein, Petitioner alleged that Respondent erred in computing Petitioner's net operating loss deduction for 1964

> ". . . by disallowing for that year $1,079,069.00 of the $22,279,949.71 claimed by Petitioner as its cost of goods sold for that year. The Commissioner's adjustment included in closing inventory on December 31, 1964, $1,079,069.00 of unsaleable goods which were obsolete or excess, and which Petitioner had excluded from such inventory. The Commissioner also erred in requiring that Petitioner's claim for cost of goods sold in 1964 must be established as an 'allowable deduction' under I. R. C. § 162 or other deduction section of the Code."

(c) The Answer filed by Respondent herein denies the relevant allegations of the Petition, but does not raise or advert to any legal theories other than those contained in the SND.

(d) Petitioner is prepared to establish at trial that the $1,079,069.00 at issue herein was properly included in its computation of cost of goods sold for 1964 and that there is no legal requirement that Petitioner establish this or any portion of its cost of goods sold as a deduction under I. R. C. § 162 or any other section of the Code, for the reason that cost of goods sold is a constitutionally required deduction from gross receipts in calculating gross income as defined in I. R. C. § 61.

(e) At a recent conference, counsel for Respondent indicated that Respondent may assert at trial that Petitioner is precluded from including the amount in issue in its computation of cost of goods sold for 1964 on the ground that Petitioner allegedly changed its method of accounting that year without the consent of the Respondent in violation of I. R. C. § 446(e). While that theory had been mentioned, without citation of any section of the Code, in the Revenue Agent's Report (Form 1907) issued October

16, 1967, it was not contained in the SND (issued June 20, 1969), and therefore it was only recently that Petitioner learned that Respondent might rely on that theory at trial.

(f) Petitioner contends that if I. R. C. § 446(e) is put in issue by Respondent in this proceeding, it will constitute the introduction of a "new issue" within the meaning of Rule 32 of the Rules of Practice of the United States Tax Court and, therefore, that the burden of proof on such new issue should be upon Respondent pursuant to the requirements of Rule 32.

(g) Petitioner believes that a ruling by the Court, at the earliest possible date, on who will bear the burden of proof if Respondent chooses to put I. R. C. § 446(e) in issue is necessary in order to permit a fair and complete preparation for and presentation of Petitioner's case at the trial. If Petitioner should be deemed to have the burden of proof to establish that it did not change its method of accounting, its preparation for trial and presentation of its case will be substantially different, requiring additional evidence.

2. (a) Counsel for Respondent has also indicated that if Petitioner prevails on the merits of this case, Respondent will rely on the theory that part or all of the amount in controversy should have been included in Petitioner's cost of goods sold in years before 1964, precluding its inclusion in 1964.

(b) Petitioner contends that the excess inventory items at issue herein were properly includible in cost of goods sold when they were identified as excess by management in 1964. As a result, Petitioner believes that introduction of voluminous proof concerning the year of production, the year of purchase, patterns of consumption, etc. will not be necessary in the trial of this case.

(c) Petitioner further believes that the mitigation provisions of I. R. C. § 1311 *et seq.* (and especially I. R. C.

§ 1312(1) relating to double inclusion of an item in gross income) are applicable, and will permit Petitioner essentially the same tax benefit regardless of whether the items at issue herein should have been excluded from Petitioner's gross income as part of its cost of goods sold in 1964 or in some prior year. This also would eliminate the need for the evidence referred to herein.

(d) In the event the issues described in Paragraphs 2(b) and 2(c) of this motion are decided against Petitioner, it further believes that Petitioner and Respondent will be able to review the books and records of Petitioner as part of a Rule 50 calculation and reach agreement concerning which year items should have been included in cost of goods sold. This too would eliminate the need for introduction of such evidence.

(e) Because it would not be necessary if the Court finds in favor of Petitioner in accordance with Paragraphs 2(b) or 2(c) hereof; if a stipulation is agreed to as contemplated in Paragraph 2(d); or if the Court's decision is adverse to Petitioner, and in the interest of saving the time of the Court, Respondent and his counsel and Petitioner and its counsel, Petitioner requests that the trial in this matter be limited to the other issues, excluding any factual inquiry into the year specific items of inventory became excess. Petitioner further requests that the record in this proceeding remain open pending the Court's decision so that if Petitioner prevails but is called upon to establish the year the goods became excess, and if resolution is not possible under the procedures described in Paragraphs 2(c) and 2(d) hereof, then in such event Petitioner may introduce relevant evidence to establish the year in which said inventory became excess.

Because of the importance of both of the issues raised in this motion, and because of their effect on both Petitioner and Respondent in preparing and presenting their

case herein, Respondent requests that the Court expedite consideration of this motion and the issuance of its ruling hereon.

WHEREFORE, it is prayed:

1. That both motions be granted:

(i) that the Court rule that Respondent has the burden of proof if it puts I. R. C. § 446(e) in issue herein; and

(ii) that the record in this case shall remain open after the trial and for a reasonable period after the decision herein for the purpose of receiving evidence concerning the year or years in which items of inventory became excess and unsaleable if by virtue of the decision herein such evidence is relevant to a determination of Petitioner's tax liability; and

2. If Respondent does not agree to the issuance of the rulings requested herein, that a hearing on both motions be heard at a convenient date on or prior to June 7, 1972, at which time Petitioner will present a memorandum of law in support of these motions.

/s/ MARK H. BERENS
Mark H. Berens

/s/ LEE N. ABRAMS
Lee N. Abrams

/s/ JOHN E. ALLEN
John E. Allen

Counsel for Petitioners
231 South LaSalle Street
Chicago, Illinois 60604
STate 2-0600

Of Counsel
MAYER, BROWN & PLATT
231 South LaSalle Street
Chicago, Illinois 60604
STate 2-0600

[CAPTION OMITTED]

ORDER

Pursuant to Order of the Court on May 30, 1972, petitioner's Motion for Order (i) Establishing Burden of Proof on New Issue and (ii) to Keep Record Open After Trial for Proof of Year in Which Inventory Became Excess, filed on May 25, 1972, was called for hearing at the Motions Session of the Court beginning at 10:00 A.M. on June 14, 1972. Counsel for petitioner and counsel for respondent appeared to argue their respective positions. After full consideration and for reasons appearing in the record in this case, it is

ORDERED that petitioner's motion filed on May 25, 1972, is hereby granted and the burden of proof shall be on respondent under the conditions set forth in petitioner's motion and the record shall be kept open after trial under the circumstances set forth in petitioner's motion.

/s/ WILLIAM A. GOFFE
Judge

Dated: Washington, D. C.
June 14, 1972

[Caption Omitted]

AMENDMENT TO ANSWER

[Filed June 22, 1972]

The Respondent, pursuant to the views expressed by the Court in response to petitioner's motion filed with the Court on May 25, 1972, with respect to the burden of proof as to whether a change of accounting method occurred in 1964 within the meaning of section 446(e) of the Internal Revenue Code of 1954, and as to whether such issue was properly before the Court, but reserving all of his rights in this matter and without conceding the correctness of any such views, adds after paragraph 6. and prior to the prayer the following allegations:

7. In Further Support of the determination in the statutory notice herein set forth as adjustment (a) to income for the taxable year ended December 31, 1964, the respondent alleges:

(a) In computing its inventory as of December 31, 1964, petitioner applied the procedures described in subpargaraph 5.(c)(i) and (ii) of its petition herein.

(b) Such procedures were not applied to petitioner's inventory as of December 31, 1963.

(c) Petitioner did not secure the consent of the Secretary or his delegate to the use of said procedures.

(d) The adoption of said procedures constituted a change of accounting method within the meaning of section 446(e) of the Internal Revenue Code of 1954.

Wherefore, the respondent prays that the Court grant the prayer requested in his answer.

/s/ Lee H. Henkel, Jr. (GTD)
Lee H. Henkel, Jr.
Chief Counsel
Internal Revenue Service

Of Counsel:
Frank C. Conley
Regional Counsel
Seymour I. Sherman
Attorney
Internal Revenue Service
Room 1622 - 35 East Wacker Drive
Chicago, Illinois 60601

[CAPTION OMITTED]

REPLY TO AMENDMENT TO ANSWER

[Filed June 22, 1972]

Petitioner, for reply to the allegations affirmatively set out by the Respondent in his Amendment to Answer, admits and denies as follows:

7.(a) Admits that in computing its inventory as of December 31, 1964, petitioner applied the procedures described in subparagraph 5.(c)(i) and (ii) of its petition herein.

7.(b) Petitioner has insufficient knowledge and information upon which to determine the truth or falsity of the matters alleged in paragraph 7(b) and, therefore, denies the allegation that such procedures were not applied to Petitioner's inventory as of December 31, 1963. Petitioner does state that Petitioner applied the lower of cost or market method of accounting in determining its closing inventory as of December 31, 1963 and December 31, 1964, as well as in all preceding and following years to date.

7.(c) Admits that Petitioner did not secure the consent of the Secretary or his delegate to the use of said procedures.

7.(d) To the extent that this allegation constitutes a conclusion of law, Petitioner neither affirms nor denies the allegation. To the extent that it constitutes a factual allegation, Petitioner denies it.

WHEREFORE, it is prayed that the affirmative relief requested by the Respondent in his answer be denied.

MARK H. BERENS
LEE N. ABRAMS
JOHN E. ALLEN
Counsel for Petitioners
231 South LaSalle Street
Chicago, Illinois 60604
STate 2-0600

Of Counsel:
MAYER, BROWN & PLATT
231 South LaSalle Street
Chicago, Illinois 60604
STate 2-0600

[CAPTION OMITTED]

STIPULATION OF FACTS

[Filed June 22, 1972]

1. Petitioner is a corporation organized under the laws of the State of Delaware, with principal office and place of business at Aurora, Illinois. Its corporate income tax returns for the calendar years 1960 to 1965, inclusive, were filed with the District Director of Internal Revenue at Chicago, Illinois. True and correct copies of said returns are annexed hereto, made a part hereof, and marked as Joint Exhibits 1-A to 6-F, inclusive.

2. At all times pertinent prior to 1964, petitioner's inventory was valued at the lower of cost or market. Petitioner's 1964 return, in answer to a printed question with respect to the valuation of inventory, states that inventory for that year was also

valued at the lower of cost or market, and that there was no substantial change in the manner of determining quantities, cost or valuations between the opening and closing inventories.

* * *

6.(a) Beginning in 1960 an account was created on petitioner's books and designated "Reserve for Inventory Valuation" (hereinafter "RIV"), which was an inventory contra-account, for the purpose of amortizing over a ten-year period the inventory value of parts and accessories kept in stock for discontinued tools, *i.e.*, tools no longer currently produced. An entry in the amount of $116,244.52 was made in this account as of 12/31/60, representing a 100% write-off of such parts and accessories for tools which went out of production during or prior to 1950, and corresponding write-downs on the basis of a ten-year amortization of such parts and accessories for tools which went out of production between 1951 and 1959, the latter receiving a ten-percent write-down.

A further addition of $30,966.35 was made in 1961, bringing the balance as of 12/31/61 to $147,210.87. As of 12/31/63 the balance in the account was in the amount of $152,117.00.

(b) During the first three quarters of 1964 $22,090.00 was added to the RIV account, resulting in a balance of $174,207.00 in the account as of September 30, 1964.

(c) For each of the years 1960 to 1963, inclusive, the net addition during the respective taxable year to the RIV reserve was reflected as a deduction in the computation of the closing inventory figure shown in the return.

7. In 1964 there was a major change in petitioner's management. New management concluded that existing inventory quantities were excessive.

8. Incident to closing the books and preparing its financial statements as of December 31, 1964, petitioner's new management undertook an analysis of its closing inventory as follows:

(a) A physical inventory was taken at all factories and branches.

(b) The remaining items of inventory (after the write-off described in the last sentence of paragraph 3, *supra.*) were written down as hereinafter described. The total number of inventory items involved were:

Raw material items	4,297
Work-in-process (material and parts) items	1,781
Finished parts (service and production) and accessories	33,670
Finished tools	4,344
Total number of inventory items	44,092

Two procedures were utilized in writing down the inventory described in paragraph 8.(b).

9. The first procedure was as follows:

(a) For each item, where such information was available, requirements for 1965 and later years were projected on the basis of actual "usage" during 1964.[1] For finished tools, "usage" was based on 1964 sales; for finished parts and accessories, "usage" was based on 1964 sales (for service parts) and 1964 production (for parts incorporated in tools); for raw material and work-in-process, "usage" was based on 1964 production.

(b) Utilizing the data obtained from the foregoing procedure, an inventory aging schedule was prepared which

1. Petitioner contends that there were adjustments for then known conditions that were expected to increase or reduce future requirements for some items, and reserves the right to offer evidence thereon. Respondent does not stipulate to the correctness of this contention, other than to agree that petitioner may introduce evidence consistent with its reservation herein.

compared the December 31, 1964 inventory quantities and the extended gross usable inventory values, per paragraph 9.(a) hereof, with the estimated market demand.

(c) Gross usable inventory values were then reduced as follows:

(i) That portion of the supply of each item of inventory not in excess of the amount determined by management to represent twelve months' "usage" was not written down.

(ii) As to each inventory item, that portion in excess of twelve months' "usage" but not in excess of eighteen months' "usage" was written down 50%.

(iii) As to each inventory item, that portion in excess of eighteen months' "usage" but not in excess of twenty-four months' "usage" was written down by 75%, *i.e.*, to 25% of the prior book figure.

(iv) As to each inventory item, that portion in excess of twenty-four months' "usage" was written off completely.

10. In addition, a second procedure was applied to the closing inventory as of December 31, 1964 at petitioner's LaGrange Park and Cincinnati plants. This was done because, in the opinion of management, data as to prior "usage" at those locations was inadequate to forecast future requirements accurately. This latter write-down in the amount of $160,210.00 is the write-down referred to in paragraphs 5(c)(ii) of the petition herein.

A summary prepared by petitioner of the write-downs of inventories made pursuant to this second procedure at the LaGrange Park (referred to therein as "Speedway") and Cincinnati plants is annexed hereto, made a part hereof, and marked as Petitioner's Exhibit 13.

*   *   *

[Caption Omitted]

[Transcript of Proceedings—22 June 1972]

Appearances:

Messrs. Mayer, Brown & Platt, By: Messrs. Mark H. Berens, Lee N. Abrams and John E. Allen, 231 South LaSalle Street, Chicago, Illinois, on behalf of the Petitioner;

Mr. Seymour I. Sherman, IRS, Chicago, Illinois, on behalf of the Respondent.

[i]

CONTENTS

Witnesses

Exhibits

* * *

[3] Mr. Sherman: Very well. Respondent moves at this time for leave to file the Amendment to Answer and asks leave of the Court to file the Motion and the attached Amendment to Answer accordingly.

I would note that at the time we discussed this matter in chambers, and I immediately went out and dictated the Motion and the proposed Amendment to Answer, I did not have before me a copy of the Order of the Court which is pursuant to a motion by Petitioner which had been argued in Washington on the 14th. Accordingly, I was unable to characterize any of the matters in terms of such Order, and had to use the expression relating to the expression of views by the Court.

I have since received the order and I would [4] ask that the Court consider that any statements with respect to the Court having expressed its views be read in the same light as the Court having so ordered with respect to the matters that have been argued in the Motion heard in Washington on the 14th.

The Court: Very well. Does the Petitioner still object to the filing of the Amended Answer?

Mr. Berens: First of all, we do not object on the grounds of time limits of the Motion to Amend. We continue our position in that regard.

We think, rather than having this Motion and the Amendment viewed as meaning something other than what it says, that it ought to be redrafted and resubmitted referring to the order of this Court on the interlocutory motion that has been argued by the government and decided by this Court.

Further, and quite apart from that, cleaning the documents up, we object to the reservation by the Respondent to reargue the motion that was argued in Washington by Respondent that was delayed one week in the argument so that Respondent could be prepared.

Mr. Sherman: If the Court please, the statements which I made with respect to the matter of the Order not having been before me in no way affect the substantive allegations in the Amendment to Answer.

[5] Also, there is no statement either in the Motion or in the proposed Amended Answer with respect to rearguing a Motion.

The sole statement there is, "But reserving all of his rights in this matter and without conceding the correctness of any such views," and this is the position I will adhere to.

Mr. Sherman: I would point out that there was no Order requiring an Amendment to Answer to be filed. The Order, rather, ordered that the burden of proof with respect to the change of accounting method be on Respondent.

The Court: Well, that is correct. I did not order Respondent to amend its Answer. I pointed out at the hearing that I would give the Respondent the opportunity to amend prior to trial, which, of course, Respondent is now doing.

I did it because I felt this was something that the Respondent bore the burden of proof on, and it should be pleaded.

I think I will overrule the Petitioner's Motion because I think the record is clear that this is not based on the views of the Court subsequent to the Order of the Court dated June 14, 1972, but I do want the record to be clear as to what did transpire at this pre-trial conference because no reporter was [6] present.

I will point out to some extent my basis for ruling on this Motion as I did.

The Petitioner filed a Motion on May 25, 1972. The Order was issued on May the 30th and served on Respondent on June 1, setting a Motion for hearing on June 14th.

Petitioner filed a Memorandum of Law. Respondent did not file a Memorandum of Law.

This hearing was set prior to the Calendar Call in order that the burden of proof might be established prior to the trial. I find this the logical, expedient way to handle something like this, so that if the burden of proof is going to be shifted, it will grant both parties an ample opportunity to rely on that prior to trial and obviate the necessity of continuing this case for the second time.

At the hearing in Washington, Respondent relied on the case of Arthur Soren, S-o-r-e-n, a 1958 case, cited at 29 Tax Court

959. That case involved a statutory notice which merely stated that a distribution from a corporation was taxable to the Petitioner at ordinary income tax rates.

Petitioner contended that if the defendant's theory which he proposed in that case that this was [7] income from a collapsible corporation, that it was new matter, and the Respondent should plead this and prove it.

Judge Opper, in deciding the issue against the Petitioner, held that because the statutory notice was in general terms, that such general terms would include the theory advanced by the Respondent.

In so doing, he distinguished cases previously decided by the Court of W. H. Weaver, 25 TC 1067, and Thomas Wilson, 25 TC 1058. In fact, Judge Opper himself had decided the Weaver case. He pointed out that in Weaver and Wilson the statutory notice was specific and Respondent attempted to rely on the theory not covered by the specific sections of the Code referred to.

I would like to state that the basis of my ruling on the Motion in Washington was that the statutory notice in this case was specific in that in this adjustment it relied on Section 162 of the Code.

It also had a phrase, "or any other section of the Internal Revenue Code," which I don't think puts anyone on notice as to what the issue is.

Therefore, that was the basis of my ruling on the Motion.

[8] Now, I did it at that time because I think it was important to do prior to the trial, and I can assure the Petitioner that the Respondent is reserving his objection to my ruling and wants to argue it on brief after the trial of the case, that I can assure Petitioner that I will give it very little weight because, to me, this is a matter that must be established prior to the trial of the case. But, if Respondent somehow convinces me that I ruled wrong, I will not decide the case against Petitioner on the basis of Petitioner's failure on burden of proof, but will instead

ask for a further trial of the case to permit the Petitioner to put on further proof because I think the burden of proof ought to be established prior to the trial, and I am not going to jeopardize the Petitioner's case by later saying that the Petitioner bore the burden of proof. I just want the record clear as to the reason for my ruling and the reason for my ruling on the Motion this morning.

So, I am granting the Motion to file the Amendment to Answer. I understand Petitioner has a Reply and a Memorandum to file.

Mr. Berens: Well, the Memorandum, in effect, states the arguments I just made for the record, and [9] the Reply would assume that the Amended Answer would be accepted by the Court, and the Reply directs itself entirely to denying or admitting the allegations in the Amended Answer.

The Court: Very well. Does the Respondent have objections to filing the Reply?

Mr. Sherman: No, Your Honor, but I will reserve the right. I just glanced at it this morning, and I believe there is one portion which is subject to a Motion with respect to striking as frivolous, and I would reserve the right to file such a Motion.

The Court: Strike as what, frivolous?

Mr. Sherman: To strike one denial in the Petition as frivolous. The Petition denies knowledge or information as to how the Petitioner computed its closing inventory balance as of December 31, 1963. It denies knowledge as to whether or not it applied to that closing balance the procedures which have been stipulated and are in issue in this case.

The Court: I take it you are referring to the Reply.

Mr. Sherman: That's correct, Your Honor.

The Court: I think you stated "Petition." You may reserve that objection.

Mr. Berens: Your Honor, that reservation [10] puts us in the same type of problem that we had that motivated our Motion in Washington to establish where the burden of proof is.

The allegation in the Amended Answer was that the procedures followed by the Petitioner at the end of 1964 in valuing excess inventory were not followed at the end of 1963.

Now, normally the Petitioner is a corporation, and normally it is aware of what it did from year to year, but we have a rather split personality situation here.

The corporation, at the end of 1964, was under entirely new management. To the extent that there were holdovers, they were not involved in this inventory evaluation.

We know what was posted to the books at the end of 1963, in valuing the inventory. We do not know, and we have not been able to find any working papers that indicate what procedures were used at the end of that year to post that amount. For all we know, procedures similar to those followed at the end of '64, that is, designed to reduce the inventory to what management thought was net realizable value, were followed at the end of '63, but that they concluded the amount was very small. I think the posting [11] at the end of '63 was something like $5,000.

Now, this is not a frivolous denial on our part. We received this Amended Answer the day before yesterday, in the late afternoon, and we drafted our reply yesterday noon, and at that time we were unable and the Petitioner was unable to determine what, in fact, had been done in 1963, in valuing the excess inventory.

Now, I want to make myself clear on this: We know this 10 per cent, 10-year evaluation procedure was followed in '63, that had been followed since 1960; that we know, but we don't know what else was done, if anything, and I think that at some point during the trial, and preferably at the outset, and while our principal company witness is on the stand, that we get a determination on this—I should put it differently—that Respondent make up its mind whether it is going to move to require us to amend this paragraph of the Reply or not, because if we are forced to amend it, we will have to present additional testimony.

If we are not forced to amend it, we will proceed as we had intended to proceed all along, and if Respondent, who has the burden of proof on this issue, wants to call company officials, present or [12] past, that's his prerogative at his time, when he presents his part of the case.

The Court: May I see the pleadings, please, the Amendment to the Answer and the Reply?

(Document tendered to the Court.)

The Court: Based upon the representations of Counsel for the Petitioner that the management of Petitioner changed—did I say based upon the representations of Counsel for the Petitioner?

Mr. Berens: Yes.

The Court:—that Petitioner's management was changed in the year 1964, I believe those representations were made in the hearing on the Motion before the Court in Washington, and the representations made this morning, which I assume the Petitioner will prove as part of its case, I find that the paragraph of the Reply, being Paragraph 7(b), the Reply to Amendment to Answer, is not frivolous, and, therefore, it will not be struck; that any allegations of the method applied to the inventory as of December 31, 1963 being part of the new matter raised in the Answer, the burden of proof rests on the Respondent to come forward with the proof.

Therefore, the objection is overruled and the Reply to Amendment to Answer is filed.

[13] Now, are there any other preliminary matters to take up?

Mr. Berens: None that I know of, Your Honor, other than the objections to some of the exhibits and the filing of a stipulation of issues which—is that here?

Mr. Sherman: No, that will be brought here and can be filed at any time this morning.

Mr. Berens: Oh. All of the issues besides the inventory issue and the bad debt issue have been stipulated by the parties, and that will be filed today.

The Court: Very well.

I believe in the proposed Stipulation of Facts, Respondent objects to Paragraph 13 of the proposed Stipulation.

Mr. Sherman: Yes, Respondent has objected to Exhibits 15, 16 and 17, Your Honor.

The Court: I think you object to Paragraphs 13 and 14 on the grounds of materiality and relevancy.

Mr. Sherman: Right.

Mr. Berens: Your Honor, we had understood it was an objection only to the exhibits, not to the material in the paragraphs.

Mr. Sherman: That is correct, Your Honor.

[14] The Court. You are correct. Respondent objects to Exhibits 15, 16 and 17.

Mr. Sherman: These matters all concern subjects substantially after the end of the taxable year, particularly in regard to Exhibit 17, which is a study of disposition of inventory from 1965 to 1971.

Exhibits 15 and 16 are the amounts claimed as excess inventory in the account as of the end of 1965 and 1966, and we are dealing with a question of an inventory procedure, and the inventory in the year 1964.

The Court: With respect to Exhibit 15, I find Exhibit 15 to be material and relevant because the taxable year 1965 is also before the Court.

Respondent made no adjustment to inventory for that year by reason of the method employed by Petitioner. I find Exhibits 15 and 16 both to be material and relevant because Regulation Section 1.471-2(b) provides that "The inventory method employed by the taxpayer shall be consistent."

I think it is material and relevant to show consistency following the taxable year involved.

With respect to Exhibit 17, Exhibit 17 attempts to—I suppose the Petitioner purports or alleges that it attempts to verify the correctness [15] of Petitioner's method of valuing inventory.

I feel this is relevant and material, and I will overrule Respondent's objection to that exhibit.

Therefore, I will overrule Respondent's objections to Exhibits 15, 16 and 17.

Now, I understand that the Petitioner objects to Exhibits—

Mr. Berens: M—

The Court: M and N.

Mr. Berens: Your Honor, yes, of Respondent.

The Court. Now, would you like to explain why you contend those are not admissible?

Mr. Berens: We have two objections to them, Your Honor. One being on the relevancy and the materiality of the mere pleadings in two civil adversary proceedings in which Thor happened to be a defendant.

The issue in those proceedings did, indeed, involve its accounting in 1964, not only in excess inventory, but in all kinds of other, both inventory and non-inventory areas. It involved contentions of fraud on the parts of some of the members of management, misleading financial statements, and so on.

The basis of that suit has some common basis with this one, insofar as the accounting of the [16] company is the underlying fact, but the allegations in the various pleadings do not establish their own truth.

As to the issues of this case, they are essentially hearsay, except insofar as pleadings by Thor could be treated as admissions against itself, and as to that aspect, we obviously have no objection.

The second basis of our objection which relates to, but is distinct from the first, and that is the competency, and in particular I focus on the pleadings of the parties to those suits other than Thor. They were attempting to either establish liability of Thor, or in some cases were attempting to deny their own liability.

In either event, the case was never tried and none of the pleadings are anything more than normal pleadings; that is,

allegations of unproved facts, and they are not only not material or relevant to this case, they are not competent.

The Court: Mr. Sherman?

Mr. Sherman: Your Honor, these pleadings involve two suits in which this Petitioner was the party in which not just an element but a very substantial element of the allegations with respect to improper prior accounting treatment dealt with them.

[17] Now, certainly Thor's own pleadings, the statements which it made with respect to the status of its inventory, are admissible against it in any subsequent proceedings as admissions. The other pleadings in this case are essential in order to know what it is Thor is pleading to, what is it denying in its pleadings, what is it alleging.

Thor was not merely a defendant in these cases, it was a defendant and a counterclaimant against its former accounting firm and possibly other parties, and I think that these pleadings are important and throw considerable light not only upon the question of the method of accounting, the propriety of the actions taken, but even on the question as to what had, in fact, been done with respect to December 31, 1963 inventory.

Here is the same Petitioner which, in its Reply, tries to hide under the table by saying, "We don't know what they did," but they know enough to allege in a pleading before the Federal District Court that they know pretty well what was done. I think this is highly pertinent.

The Court: Well, I think the subject matter of those lawsuits probably is material and relevant to the trial of this case, and I will overrule [18] Petitioner's objections. In so doing, I will point out that allegations of parties other than the Petitioner herein, Thor, will not be accepted as facts, but are merely allegations of fact not going to prove the matter of things herein to be true, except to the extent that Thor admitted such facts as being true.

Now, any allegations of Thor I will accept as being true. If they are against Thor, then I would say they would be admissions against an interest.

I do not think that allegations of Thor in those pleadings with respect to its inventory procedures at the end of 1963 in any way affect my decision earlier on the frivolity of the Petitioner's Reply, because I am not certain whether those allegations were prepared by prior management of Thor or present management of Thor. So, my ruling as to the frivolity still applies, but I will overrule Petitioner's objections as to those exhibits with that understanding.

Mr. Berens: Your Honor, could I have about 30 seconds to talk to the president of the company to establish the facts in my mind and see if I want to make a further point on this?

The Court: Certainly.

(Whereupon, a short recess was taken.)

[19] Mr. Berens: We have nothing further on that point, Your Honor.

The Court: Very well. The Stipulation of Facts, together with the Exhibits 1-A through 12-L, inclusive, Exhibits 13 through 18, inclusive, Exhibits M and N will be received in evidence and made a part of the record.

(The Stipulation of Facts and the documents previously marked for identification as Joint Exhibits 1-A through 12-L inclusive, Petitioner's Exhibits 13 through 18, inclusive, and Respondent's Exhibits M and N were received into evidence.)

The Court: May we have Petitioner's opening statement?

Mr. Berens: Your Honor, before I start that, I would like to ask Counsel for the Respondent if he was going to introduce certain other exhibits that he mentioned to us.

Mr. Sherman: Yes. I didn't know whether Petitioner's Counsel would prefer that I wait until Respondent's case, or if he prefers to have this done at this time, I would be glad to do so.

[20] Mr. Berens: I have no preference.

Mr. Sherman: Do you want these marked as Joint Exhibits?

Mr. Berens: Well, I am not sure what you have got right now.

(Whereupon, there was a discussion off the record.)

Mr. Berens: Why don't you mark them as your exhibits, because we have a partial competency objection to them.

Mr. Sherman: Okay. So, we have a total here of six. These would be Respondent's Exhibits for identification.

All right, these will be Respondent's Exhibits O—

The Clerk: O?

Mr. Sherman:—which is the 1963 Annual Report of Thor Power Tool.

Respondent's Exhibit P, which is the 1964 Annual Report.

Respondent's Exhibit O—

The Clerk: You just had O.

Mr. Sherman: I am sorry, Q, Respondent's Exhibit Q, which is the 1965 Annual Report.

Respondent's Exhibit R, which is the Form [21] 10-K, a copy of the Form 10-K, filed with the Securities and Exchange Commission.

The Court: What is the date on that one?

Mr. Sherman: That would be for the year 1965.

Respondent's Exhibit S, which is a Form 8 Amendment to this Report for the—also for the year 1964.

And Respondent's Exhibit T, which is the Form 10-K Annual Report filed with the Securities and Exchange Commission for the year 1965.

Respondent moves at this time for admission of the foregoing Exhibits O through T, inclusive, into evidence.

The Court: Does the Petitioner have any objection?

Mr. Berens: We have no objection to their admission, except for that portion of each of those exhibits which includes the opinion of the independent public accountants in the years involved and the related notes of the public accountants. In other words, that portion of each of those documents, that is

the work of the public accountants. This is hearsay as to Thor, and if the Respondent wants to put those portions in, he will have to put them in through a [22] witness who knows of their authenticity and will be subject to cross examination.

Mr. Sherman: If the Court please, these statements are essential parts of these documents. Furthermore, these accountants are the agents—the Petitioner's accountants, we are talking about now. These accountants were Petitioner's certified public accountants who Petitioner hired to make these statements, and, in fact, would not have filed these reports without having done so.

This is an amazing situation; Petitioner wants to repudiate its own public accountants.

Mr. Berens: It doesn't seem too amazing. Petitioner sued those public accountants.

Mr. Sherman: I would point out that the public accountants involved, the only public accountants who were sued, were its prior public accountants. It is apparently going to put on its present ones as witnesses in this case, but, in any event, I don't think that the Petitioner can fragment itself because of a change in management and say, "We are a new taxpayer. Let's start a new ballgame."

These are Petitioner's documents. These are statements by its authorized agents. They are part and parcel of those documents, and they are [23] admissible as admissions against Petitioner.

Mr. Berens: I think with respect, Your Honor, Counsel for Respondent is mixing two arguments here. We are not objecting to these documents insofar as they were the product of former management, these particular documents. We are only objecting to the competency of those portions which were prepared by the independent public accountants.

Now, Respondent, I think, misstates the relationship, the well-established relationship of independent public accountants to their client. They are not agents in the sense that the client

has direct power over them. In fact, that is the very purpose of the accounting profession and its role in preparing these opinions to the financial statements, it is independence. I don't believe that there is any authority, as well as any practice or general belief, that clients of independent public accountants can direct what is going to be in the accountant's opinion to the financial statements.

Mr. Sherman: Your Honor, they are agents in the very same sense that an attorney is an agent. They can't be controlled directly by the client, but they certainly have been retained by him and speak for him.

[24] The Court: Well, I take it these statements are not mere summaries of the books and records, is that correct?

Mr. Sherman: I believe they are, Your Honor. They purport to be. They make statements as to what has been done with respect to, among other things, inventory.

The Court: Well, I think in the normal course of—

Mr. Sherman: They are notes to the financial statements.

The Court: Well, that is true, but I think in the normal course of preparing financial statements, auditors may make adjusting entries to reflect—adjusting entries to the books to reflect certain things on the financial statements.

Now, if we are talking about such adjustments, I don't think those would necessarily constitute the books and records of Petitioner. Now, if they are a mere summary of the books and records of the Petitioner, they are hearsay, unless the books and records are in the Courtroom.

However, that objection I don't believe can be made by—I doubt if that objection can be made by Petitioner, because Petitioner controls the [25] books and records.

I think the exhibits are admissible in evidence, and I am going to admit them. I think—I fail to see how they cannot be competent evidence.

Mr. Berens: Your Honor, can I—before you finally rule on this, can I interpose an emphasis that I would like to make?

We are objecting to the competency only as to the opinion of the public accountant and the notes that he puts to his opinion. We are not—

The Court: I understood you objected to everything except the opinion.

Mr. Berens: No. I misspoke, then, Your Honor.

The Court: Or I misunderstood you.

Mr. Berens: No, we are not objecting to any portion of this except—maybe we can show you the portion in one of the exhibits, and it might make it easier to understand.

The Court: Is this a standard clause that is normally on the financial statement about the opinion of the accountants?

Mr. Berens: Well, it is a standard letter that is given incident to the public publication of the financial statements; that the accountants have [26] examined the books and records, et cetera, and that they are satisfied that they fairly reflect the net worth and the operations of the year.

Now, to be very specific in this case, one of these exhibits will involve the 1964 financial statement of Petitioner. Peat, Marwick & Mitchell, who had been its independent public accountants, audited that year's books and records.

At that time, at the time that they issued their opinion, they either were sued, or knew that they were about to be sued, by the client, and it must have crossed their mind in issuing that opinion that if they gave an unqualified opinion that the books and records were correct, that they would have admitted liability on themselves for failure to having adequately audited the books and records for prior periods. So what they did in '64 is they issued a qualified opinion questioning the accuracy of the year-end financial statements for '64 of the taxpayer and, in particular, in the inventory area, which was the area with which they were most likely to be found liable on a suit, so we have almost a classic example of a competency problem here.

If the Respondent wants to put in the opinion of Peat, Marwick for 1964, it seems to me [27] that they should call

Peat, Marwick's partner who was in charge of that audit and establish the validity of that opinion as an exhibit, and permit us the normal thing of cross examining that witness as to just how independent and how accurate that opinion was that particular year.

We have not as dramatic but similar objections to the opinions of Peat, Marwick in '63, as well as '64, and to Price, Waterhouse in the annual statement for '65.

Although Price, Waterhouse at that time was not threatened with being a defendant in any suit, they were very definitely in the situation that they might be subpoenaed in the pending suit against Peat, Marwick, to testify.

The Court: Well, I think you have raised a question of fact about this statement about Peat, Marwick. I think it raises a question of fact as to whether Peat, Marwick did what it said in this printed opinion, and whether the opinion is valid, whether it is based upon reasonable approaches to the accounting method employed by the Petitioner, et cetera.

I will overrule your objection and receive these exhibits in evidence for the purpose of showing that these are the annual reports of the Petitioner, [28] and the reports contain these items.

Now, as to the opinion of the accountants, I don't think that it goes to prove the basis of their opinions, and I am not receiving it in evidence for that purpose. I am merely receiving it into evidence to show that the annual report contains a statement of the auditors, and it does not prove the truth or the correctness of the matters contained in the statement of the auditor. Is that understood?

Mr. Berens: Yes.

Mr. Sherman: I would point out that these are matters filed by the Petitioner. It wasn't filed piecemeal or in part. It was filed by the Petitioner, signed by the Petitioner's president in the case of the forms filed with the SEC, and I don't think that the Petitioner can have it both ways, to file a form and say,

"This is what we are filing, this is what we are stating to the federal government, to the Securities and Exchange Commission is our condition, but we won't adopt part of it," because if they said that, they wouldn't have been accepted by the SEC.

The Court: Well, I am sure of that, but I would imagine that the Petitioner relied on the opinion of Peat, Marwick.

Now, if Peat, Marwick and the Petitioner get [29] into a dispute about Peat, Marwick's competency to render these opinions or its errors in rendering the opinion, I don't think that is necessarily chargeable against the Petitioner.

I concur with Mr. Beren's views on the role of the certified public accountant. It is true that a certified public accountant is employed by a client to render a service, but one of the basic precepts of a certified public accountant is that his opinion is independent; that he is not under the domination of the client.

Within the Rules of the American Institute of Certified Public Accountants, there are even rules about an accountant having any financial interest in a client that the accountant examines, so I don't think that you can charge Petitioner with all the acts of an independent CPA firm.

Mr. Sherman: Do I understand that this limitation goes to the expressions of opinions?

The Court: Well, what else?

Mr. Sherman: What about expressions of fact? It appears to me that these people, in expressing, making statements of fact with respect to the financial statements, are speaking for the client, and if the client wishes to repudiate them, I think that the [30] burden is on the client to do so.

The Court: Are you talking about the statements by the auditors or statements by the Petitioners?

Mr. Sherman: Statements by the auditor. Statements of fact, now. I am not referring to expressions of opinion.

The Court: Where are those statements?

Mr. Sherman: The notes to the financial statements include facts, figures, with respect to inventory procedures. I don't

believe that these can be called statements of opinion, Your Honor.

Mr. Berens: Perhaps I can clarify this. We are not, and cannot, object to the notes to the financial statement which are the company's notes. We are objecting to the opinion of the accountants—and I have the '64—I don't know which exhibit number it is—but the '64 Annual Statement here,—

The Court: It is Exhibit P.

Mr. Berens: —and I refer to the second last page, where there is a pink bordered portion entitled "Accountants' Report," dated April 5th, 1965.

Well, in your Xerox copy it probably isn't pink. It is gray.

The Court: It isn't pink, but I think I have found the page you are referring to.

[31] Mr. Berens: And it is signed, "Peat, Marwick, Mitchell & Company." Now, there are similar accountants' reports in the other documents.

I also, before, in my objection referred to notes. I should have been more precise. I was not referring to notes on the financial statements, but I believe in the 10-K, the accountants' opinion has notes to it, and I was referring to any of the accountants' notes that are in those as contrasted with company notes which, of course, we are bound by, the company notes.

The Court: Does that clear it up, Mr. Sherman?

Mr. Sherman: Yes.

The Court. That is the way I understand the rules.

The notes to the financial statements by the company will be received for the truth of the matters contained therein. The notes by the auditors, or the accountants, to the financial statements and to the forms filed with the SEC will not be admitted for the truth of the matters contained therein.

Mr. Berens: With your indulgence, Your Honor, I would like to add one background comment.

In 1965, the SEC required Thor to restate [32] its financial statements. In fact, that is one of the exhibits introduced in evidence there, is that Amended 10-K.

Mr. Sherman: Form 8.

Mr. Berens: Form 8, was it?

Mr. Sherman: 8.

Mr. Berens: Form 8, it is an Amended 10-K.

If I recall correctly, that form is without audited accounts, and the reason—and this was at the time apparently unprecedented, the filing of a document with the SEC of a public company that did not contain an accountant's opinion, and the reason for this was the SEC concluded that Thor didn't have an accountant at that time that could certify. They were suing Peat, Marwick & Mitchell who was familiar with the accounts, and although they had engaged Price, Waterhouse at the time, Price, Waterhouse was not in a position to audit the prior year's accounts before their engagement, and so we had the situation at that time, Your Honor, where we had a public company without public accountants.

The Court: Therefore, Exhibit S, which is the Form 8, does not contain any statements by certified public accountants but, instead, it consists solely of statements by the Petitioner.

[33] Mr. Berens: Is that correct, is there anything by the accountants on that form?

There was not the normal statement in there. I am not sure if we can go as broad in your statement there, Your Honor, but we are doublechecking that.

Mr. Sherman: I would appreciate leave of the Court—these were received very recently from Counsel for the Petitioner, these particular copies which I have introduced, and they are my only copies. Since they are Respondent's exhibits, I don't imagine that they will figure prominently in the presentation of the Petitioner's case this morning. If they do, of course, they will be available. I would appreciate leave to withdraw them so that at the earliest opportunity, perhaps the first break, I can have them—I can have additional copies made for my own files.

The Court. Is that agreeable?

Mr. Berens: Certainly.

The Court: Very well. It is agreeable with the Court.

Mr. Berens: Your Honor, as far as we can tell, hastily going through that Form 8 of the Amended 10-K, there is nothing in that document from any public accountants.

The Court: Very well, if it does appear so [34] later during the course of the trial, you might want to bring it to the attention of the Court.

Mr. Berens: All right.

The Court: Exhibits O through T, inclusive, will be received in evidence and made a part of the record.

* * *

[84] Mr. Abrams: I would like to call Mr. Arthur Collins as the first witness for the Petitioner.

ARTHUR R. COLLINS, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: State your name and address for the record.

The Witness: Arthur R. Collins, 51 Baybrook Lane, Oakbrook, Illinois.

Direct Examination by Mr. Abrams.

Q. Mr. Collins, would you describe generally your principal business experience before coming to Thor?

A. After having many jobs during and after [85] school, my principal industrial experience began in 1942 when I joined Stewart-Warner as manager of the Heater Division at Chicago. Subsequently I became Chief Engineer of that Division and Manager of Research.

In 1944, the Heater Division was established as the Southwind Division, and the manufacturing and principal offices were transferred to Indianapolis, Indiana, and in 1945, I was trans-

ferred to Indiana, that is to Southwind Division in Indianapolis, as Manager of Engineering.

Subsequently, I was made Manager of Operations, which included responsibility for manufacturing as well as engineering, and in 1948 I became General Manager of the Division, and in 1957 was also elected a Vice President of Stewart-Warner Corporation. I held that position until December, 1964, when I became President of Thor Power Tool Company.

Q. Would you describe generally the products which Thor was manufacturing at that time?

A. Yes. Thor is an old line company. In fact, this is our eightieth year. Its principal business is what is called in the trade as hand-held power tools. In some respects this is a misnomer because many of the tools are so large you can't hold them in [86] your hands, such as large air-operated hoists which have a capacity of some 6,000 pounds, or large mechanically operated trowels for smoothing concrete. But generally, it is considered a hand-held power tool business.

In addition to this, Thor owns and operates the Cincinnati Rubber Manufacturing Company which is in the specialty rubber business, and at a small operation involving OEM, shaded pole electric motors.

In the Tool Division, we manufacture and sell air-operated rotary-type tools such as high speed grinders, drills, impact wrenches, nut setters, and this type of product. We manufacture a line of percussion type air tools such as paving breakers that you see them using in ripping up the concrete in the street, air-operated riveting hammers, and this type of product. We make electrically operated rotary tools such as the conventional drills, saws, impact wrenches, and this type of item. We make a line of electric vibratory type tools which are used in the construction industry for—in connection with pouring concrete. We have some gasoline engine driven tools like large power-driven trowels for smoothing concrete and large compactors for compacting the soil before you pour concrete.

[87] In the Rubber Division we manufacture belts for conveyor belting, a specialty hose, molded rubber products and also make the rubber covers for large rolls that are used in the paper industry, and as I mentioned before, the small electric motor operation makes shaded pole motors that are used by OEM manufacturers for such things as vending machines and this type of product.

Q. Are Thor's products sold to consumers as well as to these industrial users that you have described?

A. Yes. We sell these products generally to industrial accounts, contractor or construction type accounts, the service trade industry as well as the do-it-yourself. I am talking now about the tool business. The rubber part of the business is generally sold to industrial companies.

Q. In 1964, how many different manufacturing facilities did Thor have?

A. We had a plant in Los Angeles,—the Tool Division had a plant in Los Angeles, a plant in LaGrange Park, Illinois, a plant in Aurora. The rubber operation had a plant in Cincinnati and at that time we had another one in Natchez. We operate a plant in England in Tynemouth, which is near New-[88] castle, and one in Italy in Frossaco which is near Milan—I mean near Torino, excuse me.

Q. And what other locations was Thor maintaining inventories in 1964?

A. In 1964 we maintained, in addition to these plants, inventories at 23 service branches in the United States and one in Canada, and then we have a sales company in Mexico and one in Germany.

Q. And there were inventories of various products at each of these locations?

A. Yes.

Q. When were you first asked to take over the management of Thor Power Tool Company?

A. In August, 1964, Stewart-Warner, my previous employer, owned approximately 20 per cent of the share capital of Thor Power Tool Company, and at that time negotiated a purchase agreement with Thor to purchase most of the assets of Thor Power Tool Company.

This purchase agreement, among other things, provided for an audit and review of the assets and liabilities of Thor as well as the interim financial statements.

Shortly after that, the agreement was signed and I believe it was early September when Mr. Archambault, the Chief Executive officer of Stewart-Warner [89] Corporation, informed me that I had been selected to become the General Manager of what then was assumed to be the Thor Power Tool Division of Stewart-Warner Corporation.

Subsequently, during that fall, as a result of the audit and investigation that was conducted in relation to this purchase and sale agreement, the disclosures which resulted from this investigation were such that they clearly indicated that the assets of Thor Power Tool Company had been overstated, and the liabilities understated, and that the interim financial results were improperly reported.

In early December by mutual agreement between Thor Power Tool Company and Stewart-Warner Corporation, the purchase agreement was rescinded, and at the same time Stewart-Warner agreed to provide management assistance in order to try to restore Thor to a satisfactory operating position. On December 9, 1964 I was elected Chief Executive Officer of Thor Power Tool Company, and the Thor Board was expanded from nine members to 12, and I was elected a Director of Thor.

Mr. Archambault was also elected a Director, and another nominee of Stewart-Warner was subsequently elected a Director in January, 1965.

[90] Q. When did you first report to work at Thor as its President?

A. December 14, 1964.

Q. When did you begin working on the company's financial statements for the year ending 1964?

A. Almost immediately because of the disclosures which had been made prior to my becoming President, and the timing that it was close to the end of 1964. It was obvious that one of the first responsibilities I had was to prepare to issue the annual financial statements for Thor Power Tool Company in respect to the year 1964, and that to do this required a complete re-evaluation of the assets and liabilities of the company at that time.

Q. Were there particular aspects of the assets and liabilities to which you directed your personal attention particularly?

A. Yes. Partly because of experience, and partly because of disclosures which had resulted from this investigation, I concentrated on the three principal areas where a manufacturing company can get into difficulty. One is inventories; second are receivables; and, the third are accounts payable.

Q. With respect to the evaluation of the inventory, what types of inventory was Thor maintaining at [91] that time?

A. Well, in the Tool Division, Thor maintained inventories of raw materials, such as castings, forgings, steel bar, and this type of thing, in-process inventories, inventories of finished parts which were used for service, and also accessories which were sold as individual items, inventories of parts which were used to assemble finished tools, and other finished products; and, of course, the inventory of the finished tools and finished products.

Q. And at the Rubber Division?

A. The Rubber Division? Basically it was the inventories of raw materials, work in process and finished products.

Q. Would you describe the procedures which were followed in evaluating the Thor inventory at that time and before consideration was given to a possible excess inventory?

A. Well, the first thing we did was to make arrangements to have a physical inventory taken at all locations of the Tool Division and Cincinnati Rubber as of December 31, 1964. This physical inventory was then priced at 1964 inventory standards, and the priced physical inventory was reconciled to the book inventory, and the necessary adjustments made [92] so that these two figures would agree.

Q. After those preliminary steps, what major adjustments, if any, were made to inventory other than the adjustment for excess?

A. The first thing we did was to evaluate the method or the standards that were used in pricing the inventory, and in our opinion, the 1964 inventory standards at the Aurora plant were too high because they included excess costs due partly to small quantities, partly due to manufacturing inefficiencies. So we decided it would be more appropriate to utilize the 1963 inventory standards.

So the inventory was priced at the 1963 standards, and this resulted in an adjustment of $380,000, as I remember it.

Q. What kind of adjustment was that, Mr. Collins?

A. This would be a write down of the physical inventory by $380,000.

Q. What other adjustments, if any, were made before consideration of possible excess?

A. The next thing we did was to evaluate whether or not all of the items that had been inventoried should, in fact, be considered as inventory items, and we found that there were a great many that, [93] in our opinion, should not be. For example, there were demonstrator tools which had been used by salesmen as sales samples. There were some trial tools that had been in customers' places of business for many years. There were general supplies, stationery supplies. In one place, I remember there was even some lumber.

So we took all of these items, which, in our opinion, were not items which normally should be considered as being in

inventory, and these were written off, and the value of this write off was about $351,000.

Q. Were there any other adjustments made to Thor's inventory other than the adjustment for excess at that time?

A. Yes. The next thing we did is that we wrote off about $422,000 of damaged and unusuable tools. These were primarily consumer-type tools which had been returned from the customers that were defective, and were simply unsaleable. As a matter of fact, we had, as I remember, two or three trailer loads of them out in the back of the LaGrange Park plant. So these were written off.

The next step was to evaluate the inventory to determine what portions of the inventory would be [94] considered obsolete. This was a very extensive evaluation, and involved reviewing the models to see—or the finished products and tools to see whether or not they were active, to review the parts, and in many cases, we found that parts had been inventoried for products which had been developed but had never been offered for sale. There was a large quantity of parts for which there was absolutely no usage in 1964, and in those cases we considered that if there was no demand at all in 1964, that that item by definition, by our definition, was considered obsolete. And so we wrote off at that point all of the obsolete inventory, and I believe that amount came to about $1,603,000.

Q. What was the next step taken in connection with the valuation of the year-end inventory of 1964?

A. Well, at this point we felt we had what would be considered a usable inventory item by item. But we then had the task of determining whether or not in this inventory there was excess, and because of the disclosures which had been made prior—I mean associated with this purchase-sale agreement, and because of the visual observation of just going through the plant and observing the physical inventory and relating this to the sales figures, and because of the type of business we were in, it was readily [95] apparent that we had excess inventory.

Q. What aspect of the nature of your business led you to that conclusion?

A. Well, it is our experience that any business which is involved with manufacture and sale of products inevitably must have excess inventory, and one reason for this is the fact that any errors that occur in the day-to-day operation of the business, any estimates of future sales which are wrong, any of these errors which tend to create excess inventory are not offset by errors of judgment or whatever they may be in the other direction. In other words, any error that occurs, or a situation that occurs in the day-to-day operation of the business which results in an insufficient inventory, is automatically corrected by buying or making additional inventory; whereas, those events which result in excess inventory are not offset by these. So the net result of the day-to-day operation of the business is one which will have excess, and unless you operate a business, unless in your operation of your business, you must dispose of this excess currently as, for example, a grocery store does with the produce that they buy because it won't keep, so they have to dispose of it currently. If you don't have this kind of operation, you are bound to [96] have excess.

Secondly, the kind of business that Thor was in is one which involves a very high percentage of service parts and accessories, and by "accessories," I mean the attachment and devices such as drill bits and moil points and steels that are used with the tools. In fact, in 1965 over 30 per cent of our sales were in service parts and accessories. And having a large service parts business, and since a signicant portion of our business was in the industrial and in the construction field as well as the consumer field, it is absolutely essential to have service parts available where and when the customer needs them. You can't wait and manufacture service parts when somebody needs a service part. Likewise, you tend to manufacture and should manufacture these parts in reasonably economical quantities.

In addition, as I mentioned a moment ago, in estimating our sales and providing the service parts for these sales, there are going to be—you aren't going to estimate with 100 per cent accuracy, and when you estimate that the sales are going to be less than they are, you have to manufacture additional quantities in order to be able to meet that service demand. So the net result is that with your [97] service parts business particularly that—but this also applies to other portions of the business—you will inevitably have larger quantities of inventories than you can sell at any one time.

Q. You mentioned that you wanted to produce parts in economical quantities. Would you explain that?

A. Yes. The—in manufacturing parts, you have a certain fixed cost for a lot of parts, the cost of setting up the machines, the cost of processing the order, if you will, the costs which are independent of quantity, and you also have the cost which varies with quantity such as the cost of carrying inventory and things of that nature. Now, if you equate these two, there is a quantity for any given demand, if you will, that represents the most economical quantity that one should manufacture.

The difficulty is that such an estimate must, of necessity be based on your estimate of what you are going to use, and, therefore, it is not precise.

Q. What conclusions did these factors lead you to reach in determining the procedure to be followed with respect to the audit of Thor's inventory and the evaluation of it at the end of 1964?

A. Well, we concluded that there was a signifi- [98] cant excess inventory, and that it would be necessary, in our opinion, to attempt to evaluate the extent of this excess in order to properly effect the value of the inventory at the net realizable value, or market value, because while you have all these parts, and that a certain percentage of them will be used, then it is uneconomic to throw away those that you won't use because you don't know which part it is. This is the problem. If one knew,

there would be no problem, but you can't forecast. Therefore, you—it is improper, in our opinion, to value the entire inventory on the same basis as you would if you knew you were going to sell it because you know that a certain percentage of inventory is not going to be sold.

Q. What procedures were undertaken by Thor at that time to determine the amount of write down to make?

A. Well, the first thing we did was to—by reviewing the inventory to determine if there were any very large identifiable products or groups of parts that might be evaluated individually, and this we did, and we found that there were three models basically that had been introduced in recent years which were the—where the actual sales had been greatly reduced or were much lower than anticipated. [99] In fact, one of the products was a product we decided to get out of the business of. It was an oil-fired space heater which Thor had manufactured, and so our first move in trying to evaluate the excess was to take the inventory of parts for these three products, the space heater, and E-700 rotary saw, and E-800 drill, and these parts were evaluated separately and a separate adjustment was made to the inventory for an excess of I think $245,000.

Q. What procedures were followed with respect to the remainder of Thor's inventory in determining the amount of write down for excess?

A. Well, the remainder of the inventory was represented by some 44,000 inventory items, and because of the number of items, and the relatively modest quantity of any one item, we decided that it was impractical to try to evaluate the potential market, if you will, for each item individually, and yet we faced this problem of trying to relate the inventory to future usage or sales because I think it is pretty obvious that if you have an item in which you have, say, $100 worth of inventory that represents a 10-year supply, that that inventory, as compared to $100 worth of inventory that represents a year's supply, the inventory that represents 10 years' supply has inherently [100] less value

because of the things that can happen to the inventory. Some of it will be lost. Some of it may become damaged. Some of it will become obsolete because of the technological change. Some won't be sold because of the fact that you have market changes. So we were confronted with the problem, as anybody in the manufacturing field, of trying to develop a relationship between inventory quantity and anticipated usage.

So here is where I fell back on my experience of 20 years in manufacturing of trying to determine a reasonable basis for evaluating this inventory. In my previous association, we had generally written off inventory that was in excess of one year. In this case, we felt that that would be overly conservative, and it might understate the value of the inventory. On the other hand, we felt that two years—if we wrote off everything over two years, that this would be too optimistic and that we would overvalue the inventory because there is—once again, if we look at—consider the factors which affect inventory, such as technological change, market changes, and the like, that two years, in our opinion, was too long a period of time.

So what we did is we came up with a formula [101] which was somewhat in between valuing writing off, say, everything over one year as compared to writing everything over two years, and we came up with this formula that has been referred to in this Court today. We valued the first year's supply at 100 per cent; the next six years—six months' supply at 50 per cent; the next month's—six months' supply at 25 per cent, and everything over two years, zero. This was the formula we used.

Q. How did you determine what one year's supply or two years' supply would be for each item?

A. Well, in 1964, the only information available to us was past performance. When I came to the company, there was no budget or forecast for the ensuing year, so the only information available was past usage. So what we did was, we—in the case of service parts and accessories, we took the previous 12 months' actual usage as a basis for models, and we used the previous—in other words, 1964 actual usage as a basis.

Q. By "models," you are referring to what, Mr. Collins?

A. I am referring to complete tools and other completed products. In the case of parts for—used in manufacturing the finished products, we used our— [102] the quantities that were used in production in 1964. In other words, we used production usage, not sales usage. For work—for work in process, we used the production usage, and also for raw materials. So we used a combination of both actual sales and production usage for 1964 in valuing the inventory at December 31, 1964.

Q. Mr. Collins, I would like to show you a document that has been previously marked for identification as Petitioner's Exhibit 21, and ask you to examine it, please.

(Document tendered to the witness.)

By Mr. Abrams:

Q. Have you had a chance to examine that, Mr. Collins?

A. Yes.

Q. Was that tabulation prepared at your supervision?

A. Yes, it was.

Q. Are these statistics on here taken from the records of Thor Power Tool Company or are these merely the—

A. These are simply representative figures. They are not taken from any records of the company.

Q. The designations in the left-hand column, [103] Items A through E, are not purported to represent any specific product of the company?

A. No.

Mr. Abrams: If the Court please, I would like to offer this in evidence as Petitioner's Exhibit 21.

Mr. Sherman: Well, now, I did not catch this. Has this been marked in identification or offered in evidence?

The Court: It has been marked for identification as Petitioner's Exhibit No. 21.

Mr. Abrams: I am offering it.

The Court: Do you have any objection?

Mr. Sherman: Yes, Your Honor. It is really not evidence. It is a hypothetical illustration of how the formula which we have stipulated in Paragraph 9 of the Petition would happen to work in that, you know, given these particular hypothetical figures. Now, I would have no objection to this going into the record merely for the purpose of aiding the Court as a summary of what this Petitioner may testify to, or to aid the Court in evaluating what Petitioner wishes to bring out in terms of how this formula works, given these assumed facts and those assumed facts. That is all it is, though. It is simply hypothetical [104] information of how the mathematics on this formula works out. Given different facts, and for that purpose, for that limited purpose, I have no objection. But I do not believe it would be admissible as evidence in chief for any greater purpose than that.

Mr. Abrams: That is the only purpose for which it is being offered.

The Court: I understand. It is being offered to demonstrate the purpose of the formula and clarify the formula with respect to items in that nature.

Mr. Sherman: I was sure it was offered for that limited purpose, but just in order to clarify the point, and with that limitation, I still have no objection.

The Court: Very well. With that understanding, Petitioner's Exhibit 21 will be received in evidence.

Let me ask you at this point: Do you intend to offer 19 and 20?

Mr. Abrams: Not through Mr. Collins, your Honor.

The Court: There will be Exhibits 19 and 20?

Mr. Abrams: Yes. These were numbered in the order in which they were prepared.

[105] The Court: That is all. I just wanted to be sure we did not skip a number.

Petitioner's Exhibit No. 21 will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 21 was received into evidence.)

By Mr. Abrams:

Q. For purposes of clarification, would you explain—directing your attention to Item A, explain what the other numbers on that line represent with respect to that example.

A. Yes, starting from the left and going to the right, the second column represents an assumed inventory of 100; the next column represents an assumed 1964 usage of 20; and then as we proceed, to the right shows how the write down would be determined, using the formula which was used.

For example, 0 to 12 months projected usage would be 20, and there would be no write down on that quantity.

The next, from 13 to 18 months' usage would be 10, and that would be written down to 50 per cent, or 5.

[106] The 19 to 24 months' usage was 10, and that would be written down 75 per cent, to 7.5, and the remaining 60 units would be—which was beyond 24 months' requirement, would be written down 100 per cent, to 60, making a total—if you add up the third line—making a total write down for that particular item of 72½ per cent.

Q. Are the numbers shown in this chart, for example, B, C, D and E, computed in the same manner?

A. Yes, they are.

Q. In applying the formula which you have been describing, was that also applied to the three types of items which you said were written off, specifically in the amount of $245,000?

A. No, we did not apply this formula. They were written off on an individual judgment basis, that is, by evaluating those items as such. No formula was applied.

Q. Then that was one category write down for excess and the formula was second?

A. That is correct.

Q. Was there any other write down for excess applied to the inventory as of December 31, 1964?

A. Yes. We had two locations, one at Cincinnati Rubber and the LaGrange Park plant Tool Division. [107] There were certain classes of inventory where past usage information, we felt, was inadequate to properly evaluate the net market realizable value of that inventory, and so in addition to the formula, in some cases, we reviewed those inventories by class and made a determination of the additional reserve which we felt was necessary in order to reduce the value of those items of inventory to the market value.

Q. What was the amount of that supplemental write down?

A. $160,000.

Q. In determining to make the three types of write downs for excess that you have described as of December 31, 1964, what factors influenced you to make that decision?

A. The primary factor was an effort to state the book inventory at a figure which would represent the net realizable value. There was no consideration given to any other factors.

Q. Including income tax consideration?

A. Income tax considerations were not considered at all at that particular time.

Q. I am referring not only to the adjustments for excess, but also the other inventory adjustments that you have described for obsolete, for damaged, the [108] adjustments relating to the standard cost change and the adjustments for items such as supplies and demonstrators. Were all of those adjustments charged against 1964 tax and income?

A. Yes, so far as the 1964 income tax return is concerned, that is correct.

Q. Now, after writing down these items by virtue of the credit to the reserve for excess, what efforts were made to dispose of the excess spare parts?

A. Very little effort, because there is almost no market other than the normal market through normal channels for service parts. Nobody has any use for a fender for a 1967 automobile except somebody who has a 1967 automobile that needs a fender. So there is no market for service parts, generally speaking, and therefore we made no effort except through the normal channels—normal prices to sell the service parts inventory.

Q. A price reduction would not have increased the market for such products?

A. In our opinion, no, because only—once again, it doesn't make any difference how cheap the service part is. If you don't need it, you won't buy it.

Q. What efforts, if any, were made to dispose [109] of finished tools in the excess category at reduced prices?

A. In a few cases, where the quantities justified, we lowered the price and sold the inventory. This was true of the completed space heaters, for example, as with the E-700 saws. But, in the case of most of the finished tools, the quantities were quite small, and in many cases the markets for the type of tool we manufactured, particularly for industrial and construction fields, is very limited. So there is no really very feasible or economically sound way, let's say, to sell the excess inventory except through normal channels.

As a matter of fact, if one were to lower the price and try to sell some of those items, we might have less net income than if you didn't lower the price.

Q. What efforts were made to dispose of the excess work in process?

A. The excess work in process is very much like service parts. Nobody has a need for a partially completed part. There is no market for it except as scrap.

Q. What efforts were made to sell the excess raw materials at reduced prices?

[110] A. We did make an effort to try to sell some of the excess raw materials, but these efforts were met with very little success because, while there is, one would think, a market for general purpose raw materials, excluding, obviously, castings and forgings, which are unique to our products, but you might feel there is a market for bar stock or hardware items, such as nuts, bolts, screws and washers, but as a practical matter, the most likely customers, namely, other manufacturers who use these products, are really not interested and are not receptive to buying these products because even though they could buy them, perhaps at a lower price, they are unwilling to take the added risk which is involved in buying products from another manufacturer. You are not sure they meet the specifications you have and, also, where the manufacturer would have no recourse.

So, as a practical matter, except for a very few items where the quantity was large enough to justify the expense, there is no market—at least that is our experience—no market for the raw materials and hardware items.

Q. How did Thor account for excess inventory in the years after 1964?

A. We have followed, since 1964, the same basic [111] policies and principles in evaluating our inventory, including the determination of excess inventory.

However, while we followed the same basic formula, we have improved and refined the technique for determining the usage, and currently we are using—instead of using exclusively past performance, we are using forecasts of future usage, modified by past usage, and I can explain that in greater detail by item in the case of models.

We use our forecast there, that is, our budget for the ensuing year, in order to determine the probable sale of models or finished tools, finished products. The same is true of accessories.

In the case of service parts, we use past usage as a basis, however, modified in the total, to take into account the level of service parts sales we expect to achieve in the coming year.

Q. Except for that adjustment in computing usage, computing in a slightly different manner, has the formula been applied in the same way, in other words, 100 per cent for one year and 50 for the next six months, and so on?

A. Yes, it has.

Q. What consideration is given to subsequent scrapping of items, scrapping in 1965 of [112] items that were reserved against as excess at the end of 1964?

A. When we scrap an item during the year, the inventory of value of that item is charged to the reserve, and the inventory is reduced.

In other words, if we scrap $100,000 worth of material during the year, the inventory is reduced by $100,000, and the reserve is charged by $100,000—charged with $100,000, which would reduce the reserve by $100,000.

Q. And when you make the computation at the end of the year, those items are already out?

A. That is correct.

Q. Is there any special treatment for items which you sell which have been reserved against as excess? That is, if sales are much greater than expectation for a particular item?

A. There is normal sales. In other words, sales to normal channels and products are handled in exactly the same way, regardless of whether they have been reserved against or not. If they are sold as scrap, it would be different, as I have already indicated.

Q. In addition to those formula adjustments in the years after 1964, were there special adjustments [113] similar to the ones made at the Cincinnati and LaGrange Park plants in 1964?

A. There have been no special adjustments of the same type that we applied in Cincinnati and LaGrange Park—namely the type of adjustment we felt was necessary because of inadequate records or information. There have been, in one or two years, some special adjustments in addition to the formula adjustment reserve.

Q. What effects have those adjustments had on the taxable income of particular years?

A. Well, in 1971, which is the one I [remember] particularly, the reserve for excess inventory was reduced by slightly less than $100,000 because we felt that the formula, when applied to a new product, and the inventory of parts that we had for that product, overstated the reserve, or in other words, understated what we felt would be the net realizable value of

that inventory. So, after applying the formula, we made the special adjustment to the reserve, reducing the amount of the reserve for excess by something less—if I remember, it was $97,000.

Q. What effect did that have on taxable income for that year?

A. That would have increased—that would have [114] reduced the cost of sales in that year by $97,000.

Q. In the increased taxable income?

A. That's correct.

* * *

[121] Q. In applying those procedures, what—in [122] the years after 1964, what consideration was given to Thor's profits in any year?

A. Absolutely none. In fact, one of the benefits we feel in using the formula approach, where, as I mentioned a minute ago, the usage is governed by our sales forecasts and budgets, which are prepared in advance of the inventory, that there eliminates—by following this rigorous approach, it eliminates any tendency that anyone in the company might have to adjust the inventory evaluation based on some desired financial results.

Q. Were these tabulations relating to all of Thor's inventory, or only to its domestic inventory?

A. These relate only to the domestic inventories and, with one exception, Canada. We regard Canada for this purpose as part of our domestic operation. That's what we consider it.

The Tool Division, for example, includes our Canadian branch.

Q. Your Canadian branch is part of the domestic company?

A. That's right.

* * *

[123] Q. In the years after 1964, did Thor undertake the same kind of inventory audit and evaluation in all respects as it did in 1964?

A. Yes, we did. Each year we have gone through the same basic steps which I described with respect to what we did in 1964. And with respect to the excess, we recomputed the required reserve from using the basic inventory date. Taking the latest usage data, we computed the reserve required and then adjusted the balance in the reserve up or down, depending upon the required reserve that is necessary to reduce our inventory to what we believe is total net realizable value.

Q. When items are scrapped during the year, what effect does that have on the reserve provision for those items?

A. If we were to scrap, say, $100,000 worth of parts during, say, 1972, the physical—the book [124] inventory would be reduced by $100,000; the reserve would be reduced by $100,000, and then at the end of 1972, since those parts wouldn't be on hand, there would be no need to reserve against them. This is the way we handle disposal of any item which has been reserved against.

Q. In effect, it reduces the cost of sales for that year?

A. That is correct.

Q. Mr. Collins, I would like to show you a document which is already in evidence as Petitioner's Exhibit 13, and ask you to examine it.

(Whereupon, said document was tendered to the witness.)

By Mr. Abrams:

Q. Mr. Collins, are the computations on Exhibit 13 the adjustments you described as having been made in LaGrange Park and Cincinnati, the amount being $160,000?

A. Yes.

Q. And the Speedway designation on here is the name of the LaGrange plant?

A. It was called Speedway Division at that time, but the plant is located in LaGrange Park.

Q. Would you describe the manner in which the [125] $160,000 additional adjustment reflected on Exhibit 13 was computed?

A. What we did, the inventory we had, for example, at Speedway, as indicated here, was divided into several categories with the gross usable inventory value for each category, and by examining these values and the—what we feel to be a desirable reserve against them, we select appropriate percentages for each class of inventory.

Admittedly, this is not a precise way of doing it, but we felt some adjustment of this nature was in order, and these figures represented our best estimate of what was required to reduce the inventory to net realizable value. In the same way, we used the formula. This obviously is not an exact or precise science, but the formula was selected to give us what we believe to be a result representing the net realizable or market value of our inventory.

Mr. Abrams: I have nothing further, Your Honor, with respect to the inventory issue with Mr. Collins.

The Court: Would you like to cross examine?

Cross Examination by Mr. Sherman.

Q. Mr. Collins, I take it you are familiar with [126] the fact that Thor was engaged in litigation beginning in 1965 in two different lawsuits in the Federal Court. Are you familiar with that fact, sir?

Mr. Abrams: Your Honor, this line of interrogation is certainly outside the scope of Mr. Collins' direct examination. I object to it for that reason.

Mr. Sherman: I will demonstrate in connection with what I am speaking—I will ask him certain questions with respect to allegations made.

The Court: I cannot recall whether he testified about the lawsuits or not. He testified about the revision of the contract at Stewart-Warner.

Mr. Abrams: He did not testify about the lawsuit. Mr. Berens made reference to them in his opening statement, and

we had argument on admissibility of the pleadings from those cases.

The Court: I think I will sustain the objection. Of course, you can always call this witness as your witness, but I think it is not proper cross-examination.

I will sustain the objection.

By Mr. Sherman:

Q. Mr. Collins, I believe you testified that you came to Thor, was it late in 1964?
[127] Approximately what date in 1964?

A. I was elected President December 9th, 1964.

Q. And was this part of an effect of a new management team coming in to organize?

A. This was the result, as I stated in my testimony, that the rescision of the purchase agreement that had been entered into between Stewart-Warner and Thor, and Stewart-Warner's agreement with the Directors of Thor to provide management assistance to Thor.

Q. And was it contemplated that as a result of this management assistance, various changes would probably be made in the operations of the Thor organization?

A. Yes, I think that would be a fair statement.

Q. Would it be a fair statement to say that there probably would be changes in the management and selling policies of the organization?

A. It is possible. It doesn't necessarily follow, it seems to me.

Q. Well, let me put it another way.

Would it be safe to assume that the manufacturing and selling policies which had been previously carried on would necessarily be continued into the future?

A. I don't think that. What was really agreed [128] was simply to provide additional management talent. There was no specific thought or direction as to—on the part of Stewart-Warner or the directors of Thor as to what the result would be by the change of management.

Q. But this new management would be a free—would be considered free to adopt new policies?

A. Yes.

Q. And some of these policies, could I assume, differ quite radically from policies followed by its previous management?

A. Yes.

Q. Now, when you came into the company, did you anticipate that Thor would go out of business within, say, the next two years?

A. Absolutely not.

Q. Did you anticipate that all of its current tools would be discontinued within the next two years?

A. I didn't anticipate that, no.

Q. Would it be safe to assume that in all probability, and perhaps most of its currently produced items would still be produced two years from that date?

A. Not necessarily.

Q. Would you say, then, that it would be [129] entirely speculative to assume one way or the other as to whether current production would continue or be discontinued, to any degree?

A. I think it would be speculation. Certainly it would have been on my part, since I was completely unfamiliar with Thor's operation, except in a broad way.

The Court: Let us stop here for a moment for a change of reporters.

(Whereupon, there was a short interruption.)

By Mr. Sherman:

Q. Mr. Collins, in projecting future trends, is a one-year period a sufficient period of time on which to base such projections?

A. It depends on for what purpose.

Q. Well, let's assume that the new management has come to take over direction of the company.

Would the sales of the immediately previous year under the prior management be an adequate basis on which to project what would happen under sales of new management?

A. If it was the only information available, it would have to be used for this purpose.

Q. Would you agree that such a projection would be purely an estimate?

[130] A. Any projection is an estimate.

Q. Do you believe that any item of inventory which would not be sold within two years is absolutely worthless?

A. If it isn't going to be sold within two years and there isn't any market for it, the probability of it having any value is very limited.

Q. Suppose there is a market, there are actual sales within the past, and there are anticipated sales in the future, but this happens to be—

A. There is no guarantee that there is a market for anything, at least in our business.

Q. In other words, unless there is a guarantee that it will be sold, you consider it worthless?

A. On the average. Our evaluation of the inventory, one has to recognize, is done in such a way as to arrive at an overall reasonable value. Because of the inaccuracies of forecasting, it is inevitable that some of the items we assign full value to are in fact worthless. In retrospect, that is in actuality, they are worthless because the sales we are anticipating we were going to have don't materialize. Now, it is equally true that some item we assume is not going to be used is used.

But, the objective of our system is to have [131] an objective consistent fair basis of evaluating the probable market value of excess inventory.

Q. Then as to any given item, this particular procedure could prove to be quite inaccurate, couldn't it, just taking that item alone?

A. Certainly, for an individual item.

Q. Taking this procedure, let's take a hypothetical item, an inventory item which has been carried at $1 per unit prior to December 31, 1964.

Let's assume that there are 200 units on hand as of that date, and that 1964 usage was 100 units.

Now, would the total inventory figure for that item immediately before application of this procedure have been $200?

A. Would you mind repeating those numbers?

Q. Let's assume that the item has been carried at $1 a unit. There are 200 units on hand as of December 31, 1964. 1964 usage was 100 such units; that there are 100 units. It is apart from the 200 that are now left in inventory.

Would the inventory figure for that particular item, the total inventory figure immediately before the adjustment pursuant to these usage procedures, would that be $200?

A. Just to make sure I understand your question, [132] if we didn't make or buy any inventory, you are assuming that—say there were 300 units in inventory at the beginning of the year.

Q. That is correct.

A. We sold 100 units and we have 200 units left.

Q. Yes.

A. Now, if this were usable item—in other words, not obsolete, not damaged, was an item that properly should be in inventory, the gross usable inventory value assigned to that item would be $200.

Q. And what would the inventory figure for that item be following the December 31, 1964 adjustments?

A. The gross inventory would remain unchanged. The reserve against that inventory to arrive at a net inventory value, if we had the 100 units—pardon me. My arithmetic is kind of

slow—would be $137.50, if my arithmetic is correct. That would be the net. The reserve would be $62.50, and the net value after deducting the reserve to get—to reach the net realizable value would be $137.50, if my arithmetic is right.

Q. All right. Now, if we assume the same facts except that there are 1,000 units on hand as of December 31, 1964, what would the net inventory value of that 1,000 units be?

[133] A. Is the usage the same?

Q. Yes. 100 units in '64.

A. The net value would be $137.50.

Q. All right. Would the same net value be true if there was a million units in inventory?

A. That is correct. It would also mean we would have a few hundred years supply. I don't know what the arithmetic is, but on that basis of a thousand, we would have a 10-year supply, so if it were a million, I won't live long enough to worry about it.

Q. Well, let's take a slightly better selling item. Let's assume we have an item in which there are 10,000 units in stock as of December 31, 1964; that is, 10,000 after whatever was constituted in 1964 usage. 1964 usage is 100. This would be also carried in inventory originally and up to the end of 1964 at a dollar per unit. So, you would have a total preadjustment figure of $10,000.

Now, from what you have testified previously, I think we can agree that the net inventory figure as of December 31, 1964 following this adjustment would again be down to $137.50, is that correct?

A. Other things being equal. I mean it being a usable item and so forth and so on, yes.

Q. Now, if we assume that no more such units are [134] acquired or made or produced during 1965, but usage is 2,000 units, what would the net inventory figure be as of December 31, 1965 for this item immediately before and immediately after application of those procedures?

A. In 1965, you say we sold 2,000?

Q. Correct. And assume that they were sold at a dollar apiece, to make it simple.

A. So we now have 8,000 left in inventory?

Q. Correct.

A. And it still has an inventory value of a dollar apiece?

Q. No. It had that value prior to December 31, 1964. I assume the net value has been written down as of the end of the year.

A. The way we handle that, that unit continues to value in the gross usable inventory at a dollar, if we don't change the standard. So that the gross usable inventory at the end of 1965 would be $8,000.

We would then determine a new usage and reserve figure, and in this case, the 2,000 units that were sold in 1965 would be the new base for computing the future usage, so, now, in the case that you cited, the 2,000 of those units would be valued at future value, 1,000 would be valued at half that value, which [135] would be 500, and another 500 would be valued at a quarter, which I guess is 125, so we would have $2625, would be the net value of this usable inventory, and the reserve would be the difference between that and $8,000.

The Court: Could it be 2725?

Mr. Allen: I have 2750. I think the last 25 per cent would be 250.

Mr. Sherman: That was my figure also.

The Witness: Yes, I am sorry. My arithmetic is in error. So the net figure would be $2750, and the reserve would be $5250.

Mr. Sherman: Right. Excuse me?

The Witness: And the reserve would be $5250.

Mr. Sherman: That is right.

By Mr. Sherman:

Q. Now, in terms of the tax returns, though, the net figure would be the figure that would ultimately be reflected in the cost of goods sold, isn't it, in the closing inventory figure?

A. Would you repeat the question, please?

Q. In terms of the—in terms of the tax return, the income—Federal income tax returns, I take it, it is the net figure that is ultimately reflected?

[136] A. That is correct.

Q. In the closing inventory?

A. That is correct. Also the net figure is used in the opening inventory.

Q. Now, going into 1969, let's assume that there is no usage at all. The usage is zero on this item, so we will have the 8,000 or the—we still have the 8,000 units remaining at the end of 1969.

Now, would you give me the net inventory figure for these units before and after the adjustments?

A. If there was no usage in 1964, this item is to be considered an obsolete item.

Q. And I take it, then, it would be written off the book?

A. Written off and disposed of.

Q. And now, if in 1967, some usage did occur, would the amount of such usage then result in a—in putting this back into inventory?

A. Not if we already disposed of it.

Q. In other words, you are saying if there was no usage, it would be scrapped?

A. If no usage, it would be considered obsolete; the chances are excellent that it would be removed from whatever catalog or price list that the item [137] would be for sale on, and we would dispose of the inventory and wouldn't have any further demand.

Q. Are inventory items ever carried over to a subsequent year despite an absence of any usage within the immediate one-year prior period?

A. I don't doubt that there are; that we don't get around, if you will, to scrapping them all.

Q. And if that is what happened with this particular item, and for some unaccountable reason the demand arose again in 1967—and let us assume that such demand produced sales of 4,000 units—how would that be handled on the books as of December 31, 1967?

A. We would have just like any other item, as I explained earlier. We go through this complete evaluation process each year so that in the event that the unlikely occurrence that you mentioned—having an item that has no usage in one year and a high usage in another—if this should occur, then obviously, applying our formula, if we had the 4,000, they would be valued—if we started at eight, we would only have four left.

And if the sales in the previous year would be four, the 4,000 would be on the books at full value.

Q. That is, the remaining item would be revalued at $1 a unit?

[138] A. That is right. As long as we haven't changed the inventory standard.

And the reason we do that is because as we make sales, we stay with a given inventory standard for that kind of approach because the item that we sell, we sell at normal prices.

Mr. Sherman: I have no further questions.

Mr. Abrams: No redirect on the inventory. Mr. Allen will direct as to bad debts.

The Court: I have two questions to ask on the inventory issue.

Were your sales of tools made direct to the ultimate consumer or were they made through jobbers or distributors?

The Witness: In 1964, we sold tools. We sold both ways. In some cases, they were sold directly to the industrial accou..ts. We are talking now about industrial tools.

We would sell, for example, to Ford or Chrysler or Caterpillar or any of the large companies in these certain areas. In other areas, we sold through industrial jobbers or distributors.

In construction equipment, like the breakers for paving, and this sort of thing, we sold through distributors. Likewise, the consumer type products, [139] the do-it-yourself products, we sold through distributors.

The Court: Did jobbers or distributors maintain inventories to replace parts, or were replacement part requests made directly to Thor?

The Witness: It works both way. The parts for the construction tools generally were sold through the construction type distributors. The type of distributors that you use in market tends to have service facilities.

In the industrial field, some of the distributors handle service parts, but a great many parts were sold through our branches directly to the consumer. Other parts were used by our branches in repairing tools that would be sent in for repair.

So there was an inventory of service parts, both in the branches, in distributor places, as well as in some of the large industrial accounts. I mean, companies like Ford maintain a significant inventory of parts. This is one of the added problems, and because of the long pipelines in essence that you have, this larger inventory in the field, we frequently at the factory—our knowledge of sales tends to—sales of parts tend to lag the actual event.

This is one of the tendencies and one of the [140] reasons that we do have quite a lot of what turns out to be a lot of excess inventory.

The Court: Did Thor know what inventories of replacement parts were by the distributors or jobber?

The Witness: No. No, we don't have any good data of that kind.

The Court: I have no further questions.

Mr. Sherman: I just have two more questions.

Cross Examination (Resumed) by Mr. Sherman.

Q. Now, when these items were written down on the basis of no write down of an amount equal to '64 usage, and then the 50 per cent and 75 per cent write downs and write offs, was there any actual physical difference between—between various

units of these items so that you can distinguish one that was written down completely from one that was not written off at all?

A. Not until they were physically disposed of in the case of, say, obsolete items and something of that nature.

Q. Just one further question.

Did Thor enter the home appliance field in 1961—

[141] Mr. Abrams: There is nothing about 1961 in his direct examination, and the year is also, I think—there is nothing claimed with respect to anything done in '61.

Mr. Sherman: Your Honor, I think this goes to the question of the likelihood of the use, possible increased need for replacement parts, accessories, which apparently was the greatest part of this inventory.

The Court: I think it is beyond the scope of direct examination.

Mr. Sherman: I would be willing to make the witness my witness for that one question, Your Honor.

The Court: Very well.

By Mr. Sherman:

Q. Did Thor enter the home appliance field in 1961?

A. What do you mean by "the home appliance field"?

Q. Oh, toasters, home lawnmowers, the types of small appliances used in and around the home?

A. As far as I know, Thor has never been in the toaster business.

Q. I am just using that as an example. That is [142] an example.

That may not be a specific—

A. We have not been in what I would call the home appliance market.

Q. Well—

A. Now, Thor has made a lawnmower, and I can't tell you when they started to make it. I just don't know.

But of the products you mentioned, the only item that I know of that Thor has manufactured and sold is an electric-powered lawnmower.

Q. Did Thor enter a new—what it considered a new field in 1961, a new type of body?

Mr. Abrams: Your Honor, if Mr. Sherman wants to undertake a lengthy examination of Mr. Collins as his witness, okay. But this is not the time for it.

Mr. Sherman: This will be my last question.

Mr. Abrams: I withdraw my objection.

By the Witness:

A. I am not quite sure what Thor did in 1961, and I don't recall the date that Thor acquired the Speedway Manufacturing Company, and the Speedway Manufacturing Company was the company that was in largely the do-it-yourself type of hand-held power tools.

I don't know if this is what you are referring [143] to or not, but I am not personally familiar with what Thor did in 1961.

Mr. Sherman: Thank you.

Mr. Abrams: Nothing further on the inventory issue, Your Honor.

The Court: Very well.

Direct Examination by Mr. Allen.

Q. Mr. Collins, turning now to the bad debts issue in this case, you testified earlier today that upon becoming President of Thor, one of the assets of the company that you felt perhaps might present a problem and that required review was the accounts receivable.

Would you expand on that and explain?

A. Yes. As I mentioned earlier—

Mr. Sherman: Your Honor, I am going to object to that. This is such a broad question I really don't know what they are

getting into, and I think that the witness should be—should have questions posed to him, and he could answer those questions.

Mr. Allen: The Petitioner contends that factors dealing with particular accounts, collectibility thereof are relevant to establishing a bad debts reserve.

[144] The Court: I believe he testified—I believe there were three or four areas of business that he felt needed going into.

One was inventory, one was receivables, and one was payables.

I believe that was his testimony. If you want to lead him and ask him what they did about receivables, I will permit it. That should be specific enough.

By Mr. Allen:

Q. All right. Mr. Collins, taking it at the end of 1964, would you describe what, if any, reviews were conducted of the accounts receivable?

A. Yes. In 1964, as I have previously mentioned, my initial task and major responsibility was to reevaluate the assets and liabilities of the company in order to be in a position to directly report to the shareholders the status of the company, the financial status as of December 31, 1964.

And we have already covered the inventory issue, and another major asset on the balance sheet was the receivables.

At the end of 1963, the receivables were about 23 per cent of total assets. So we undertook a very careful review of the accounts receivable on [145] December 31, 1964, and the general process that was used—the technique that was used—was to evaluate individually all of the accounts that were over 90 days past due and over a hundred dollars in value.

These accounts were individually evaluated by the credit clerks who were responsible for collecting these accounts and who therefore had rather complete knowledge of the collectability or the probable collectability of each account, as these accounts that were under 100—over $100 were individually evaluated, and the portion that was assumed to be or felt to be uncollectable was determined and reserved against 100 per cent.

Then that percentage was applied to those accounts that were 90 days past due that had individually a value under $100.

Now, with accounts that were more current, we applied a—for the current accounts and those that were less than 29 days past due, we assigned a one per cent reserve. For all other accounts except the ones that we called "hard core" accounts, we reserved two per cent value.

Inter-company accounts, there was no reserve. Now, I have been speaking about the Thor Tool Division.

The Cincinnati Rubber, I believe there were only two questionable accounts that were reserved [146] against—the balance of the accounts receivable—we established a reserve of one per cent.

The experience of Cincinnati Rubber has been good.

Q. You indicated that the people reviewing these accounts had familiarity with them.

Could you describe how they acquired this familiarity?

A. Well, in our system, the individual—the accounts were segregated generally alphabetical, and the credit clerk had responsibility for the group of accounts.

It was their responsibility to not only keep track of the status of the accounts and also to approve credit for shipment against these accounts, but also to try to collect these accounts following the usual standard approaches of first telephone calls or letters and ultimately getting to the point, if they could not collect the account, by referring to it to their supervisor.

Then, their judgment that was applied individually to these accounts was reviewed by their superior who was a credit manager, and then his judgment was reviewed by the Treasurer, and ultimately the overall review of the total accounts receivable and the [147] proposed adjustments and reserves was reviewed by myself.

Q. Mr. Collins, can you tell me what, if any disallowance for tax purposes there was on the bad debt reserve taken for 1964?

A. I don't think there was any disallowance.

Q. Turning, now, to 1965, which is the year in issue, I will show you Petitioner's Exhibit 18, which has already been introduced in evidence.

Had you had a chance to review this?

A. Yes.

Q. Are the figures reflected here a summary of the analysis made at year-end 1965 with the various accounts?

A. They are.

Q. Can you tell me who conducted this review?

A. This review was performed by the same group of people —not individually—but as I indicated, we followed the same practice in '65 that we did in '64; that the initial review of what is called here "hard core" accounts was over $100, was conducted by the credit clerks having responsibility for those accounts.

And they would know—and hopefully know, and certainly know—more about it than anybody else [148] in the company as to the probable collectability of each account. But their judgment, as I indicated was reviewed by the Credit Manager and then by the Treasurer in turn.

Mr. Allen: Your Honor, I have no further questions.

The Court: Mr. Sherman?

Mr. Sherman: I have no further questions.

The Court: All right. Thank you. You are excused.

The Witness: Thank you.

(Witness excused.)

* * *

[149] WILSON J. BESANT, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir.

State your name and address for the record.

The Witness: Wilson J. Besant, B-e-s-a-n-t, 1042 Westmoor, Winnetka.

Direct Examination by Mr. Berens.

Q. Mr. Besant, would you state your profession?

A. CPA.

Q. And how long have you been a CPA?

A. Since 1956.

Q. Have you been a practicing Certified Public Accountant continuously since that date?

A. Yes, I have.

Q. From that date on, have you been associated with any firm or public accountants?

A. Yes, I joined Arthur Andersen in 1953, and I have been with them since that time.

Q. Would you describe your career with Arthur Andersen since 1953?

A. I joined the audit staff of Arthur Andersen in 1953, was promoted to Manager in 1957, and admitted [150] to the partnership in 1963, and since May of this year, I have been in charge of the Manufacturing Audit Division of the Chicago office.

Q. Would you describe in some detail what that entails, being in charge of the Manufacturing Division of the Chicago office?

A. Well, this division, as the name sounds, is responsible for all of the audits of manufacturing companies that we handle out of Chicago, and this division consists of 12 partners, 27 managers, about 65 seniors, and other staff personnel that help do the auditing work.

Q. Now, as the head of this division, what are your duties in regard to audits conducted by other partners in that division?

A. Well, we consult with each other when we feel it is necessary.

Q. Do you get any familiarity with the problems of audits of clients other than under your direct audit supervision?

A. Yes, I did.

Q. What is the relationship with Arthur Andersen with the Petitioner, Thor Power Tool Company?

A. We were appointed auditors of Thor in connection with the financial statements of December 31, [151] 1970. And I was assigned as partner responsible for that work.

Q. Would you describe, generally, the relationship of an accounting firm of independent accountants such as Arthur Andersen with their clients when they have an engagement such as you have with Thor?

A. Well, when we are engaged to make an audit, we perform an examination of the company's books and its records, and eventually issue our opinion on the financial statements as of a certain date and for the year ended that date, and these statements and our opinions are sent to shareholders.

They are also sent to the Securities and Exchange Commission and other governmental agencies.

Q. Do you consider yourself an agent or employee of your clients?

A. No.

Q. In the course of such an audit, do you make adjustments on the books of the clients?

A. No. All we do is suggest that the client record an adjustment, and if the client refuses to record an adjustment, the only thing we can do is qualify our opinion in some fashion.

So your opinion is based on your general agreement with the presentation of their financial [152] statement as to its accuracy, consistency and in accordance with generally accepted accounting principles?

A. That is right. We made an examination in accordance with generally accepted auditing standards and express our opinion, as you suggested.

Q. I believe you stated that your relationship commenced with Thor for the fiscal year 1970, is that correct?

A. That is when we first were appointed auditors.

Q. When you are first appointed auditor for a new client, are your audit procedures different than the usual procedures?

A. Yes. We follow additional procedures that we call "first time through."

Q. Would you describe those in general and their purpose?

A. Well, we have to review the financial statements for the preceding year. We are interested in the accounting policies and principles that were followed in the financial statements of the preceding year, because we mention consistency in our opinion for the current year.

We also review the clients internal accounting procedures and internal control in order to [153] determine the scope of our audit. We look at the opening balance sheet for the accounts that have a carry-through aspect to them that float through into the current year's financial statement, such as property, depreciation, earned surplus, capital stock, and also inventory as well, because closing inventory of the prior year has an effect on the income statement of the current year.

Q. In your first time through audit procedures for 1970 for Thor, would you describe in general what you did in regard to the inventory accounts?

A. We looked at the prior auditor's working papers—Price, Waterhouse—and made notes as to work they performed. We also then visited the company and looked for evidence of the work that was done in the physical taking of the inventory and in the compilation of it.

We also checked to see that it was extended correctly. We also checked the accuracy of the price, and we also were making review to see that excess and obsolete inventories were adequately considered.

Q. In regard to the excess inventory you just referred to, did you engage in any specific procedure and, if so, what were they?

A. We did review the excess inventory situation, [154] and our procedure was to select items on a hindsight basis. In our 1970 audit, we selected 150 items from the 1969 inventory, and then checked the actual usage in 1970 of these items and recomputed the required reserve for excess stock, based on this actual usage.

And we followed a similar procedure in 1971 on a hindsight basis of the 1970 inventory.

Q. Do I understand correctly, then, that for the 150 items that you mentioned in 1970, you compared the provision set up by the company on their books with what actually happened in terms of sales to those items during 1970?

A. Right.

Q. How did you arrive at the selection of 150 items sample?

A. We selected some large items—I believe in 1970 it was 20 large items—and we selected eight blocks of 10 items in a block, and then 50 items at random.

Q. Were these items—are these physically large?

A. No, I said large—I am speaking in terms of dollars.

Q. Dollar value in the inventory account?

A. In the inventory reserve.

[155] Q. In the inventory reserve account?

A. Right.

Q. These eight blocks of 10 items, were these selected at random?

A. The blocks were, yes.

Q. Do you recall what percentage of the total value in the reserve accounts that these 150 items represented?

A. I believe it was about 15 per cent.

Q. This is in terms of value?

A. Yes.

Q. Do you recall what the results of your sample were for 1970?

A. The results of our sample indicated that the reserve for excess inventory was understated.

Q. Can you remember a dollar or percentage figure?

A. I believe in 19—

Mr. Sherman: Object, Your Honor. I think we are getting into quite a period of time here. I don't think we are even close to the taxable year.

The Court: I will overrule your objection. I think he can testify as to the—his opinion as to the correctness of the procedure utilized.

There has been testimony that the same [156] procedure was utilized in later years.

Mr. Berens: Would you read the question to the witness, please.

(Whereupon, the record was read.)

Mr. Berens: I better ask the question again.

By Mr. Berens:

Q. If you remember, do you recall for 1970 either a dollar or a percentage figure?

A. I recall it was about 17 per cent understated.

Q. Understated?

A. Understated.

Q. Let me clarify:

By "understatement," you mean what?

A. I mean the reserve, based on our tests, was not large enough.

Q. Do you recall the result for 1971 based on your tests?

A. I believe our tests for '71 indicated the reserve was understated by about 4 per cent, 5 per cent.

Q. I have here, marked for identification, Petitioner's Exhibit No. 19, which is entitled "Summary of Tests of Reserves for Excess Inventory by Arthur Andersen & Company."

[157] Was the data contained on this document prepared from Arthur Andersen's working papers?

A. Yes, it was.

Q. Were these prepared under your supervision?

A. Yes.

Q. I offer this document as Petitioner's Exhibit 19.

Mr. Sherman: I would object on the ground of relevancy. I really think this is highly irrelevant. The question here is the propriety of this method, per se, which is one of the questions, and certainly this can't go to that and this can't go to the questions of change of method in 1964.

We are talking about a test that was made by assuming the very point of issue in this case, that this is a legally acceptable method, and there is some computations that in 1970 or 1971 they should have had more reserve.

I just fail to see the relevance of this kind of document or even the testimony as far as that goes.

The Court: Mr. Berens, would you like to comment?

Mr. Berens: I would like to make clear that we are certainly not offering it to establish a change [158] of accounting method, which we think is properly the burden of the Respondent to present. We are offering it as a hindsight to show that this procedure, which has been consistently followed from 1964, was in this—based on that data—not only reasonable but perhaps understated the results. It was conservative in terms of the issue before the Court.

We don't know how we can prove the reasonableness of the formula if we can't show how it worked.

We are puzzled by the series of objections that Counsel has raised to several exhibits in addition to this one, where hindsight seems to be, in his opinion, both irrelevant and immaterial; and in a practical system such as this that was adopted, there was no way,—looking at it in a vacuum—of determining whether it is reasonable.

The only way I know how to prove this is to show how it worked, and as a preliminary, we have introduced this exhibit for a series of questions to the partner in charge of the audit to

express his opinion as to the reasonableness, both from the current years he has examined and by certain other data, by inference on how it was working from '64 on.

The Court: Well, Respondent has attempted to test the validity of the method used by the use of [159] hypothetical questions, so I think that—I don't see how Respondent can object to showing any actual tests using actual figures in later years to test the validity of the method.

So I will overrule the Respondent's objections.

By Mr. Berens:

Q. I refer you, Mr. Besant—

The Court: Exhibit 19 will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 19 was received into evidence.)

By Mr. Berens:

Q. I refer you, Mr. Besant, to the last two lines on Exhibit 19 which refer to a number of items understated, and per cent of items understated, and ask you what this represents and what conclusions, if any, you derived from that?

A. Well, of the 150 items we tested in 1970 for excess inventory—128 of the items included in that group—the reserve was understated for those items—for 128 items.

It indicates that what is happening here is [160] that the sales forecast that is being used in the aging of this inventory is not being met.

In other words, actual sales are declining below the amount of sales that were forecasted for the year.

Q. Based on that hindsight that you have, both in terms of the dollar figures above and the number of items understated below, would you express an opinion of whether or not the provision in fiscal 1970 was reasonable?

A. We believe that the provision for 1970 was reasonable.

Q. Would you offer your opinion on that for 1971?

A. I would have the same opinion.

Q. Did Arthur Andersen issue a qualified opinion as to inventory for either 1970 or 1971 for this client?

A. No, we did not.

Q. You gave an unqualified opinion?

A. As to inventory, yes.

Q. Would you have issued such an unqualified opinion if this provision for excess had not been made for either of those years?

Mr. Sherman: I object to that as speculative.

[161] The Court: Overruled. I think he can give reasons why he would qualify or not qualify an opinion with respect to inventory. I don't think it is speculation. I think it goes to the heart of the opinion, so I will permit him to testify.

By the Witness:

A. We would have qualified our opinion had the company not made some provisions for excess inventory—a write down for excess inventory.

By Mr. Berens:

Q. In the course of your testimony concerning your first time through audit, I believe that you testified in addition to the sampling technique, that you had looked at earlier data in the various accounts, is that correct?

A. Historical data prior our year of examination?

Q. Yes.

A. Yes.

Q. Was there anything in that review that you discovered that indicated that the system for providing for excess inventory gave other than reasonable results in prior years?

A. No, we discovered nothing.

Q. I have here, marked for identification, [162] Petitioner's Exhibit 20, which is entitled "Summary of Income Statement Domestic Consolidation," which covers a period of years, 1962 through 1971.

Mr. Besant, was the data contained in this document taken from the books and records of Thor Power Tool Company?

A. Yes, it was.

Q. Was this document prepared under your supervision?

A. Yes.

Q. I would like to offer Petitioner's Exhibit 20 into evidence.

The Court: Any objection?

Mr. Sherman: No objection, Your Honor.

The Court: Exhibit 20 will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 20 was received into evidence.)

By Mr. Berens:

Q. Would you describe generally what purports to be shown on this summary statement here?

A. Well, it is a summary of the results of operation for each of the years from 1962 through 1971 [163] of the domestic operations.

Q. And do I understand correctly that this data basically is the same that goes into the computation of the taxable income in the income tax returns of the Petitioner?

A. Yes.

Q. From the data contained on that exhibit, would you express any conclusions, if any, that you derived?

Mr. Sherman: I think that question is extremely broad, Your Honor.

Mr. Berens: I will withdraw the question and restate it.

By Mr. Berens:

Q. From the data on this Exhibit, and from your knowledge of the provision for excess inventory by the company, would you express any opinion you have as to the reasonableness from and including 1964, on, of this provision?

Mr. Sherman: I will object, Your Honor, in that the witness has stated that he first became associated with this company in 1970, and I don't believe he is qualified to express an opinion as

to the reasonableness of something that was done prior to his association, and particularly since there were [164] numerous things done which are not part of the issue in this case and which already affect these figures.

The Court: I believe that he testified that he reviewed the workpapers involved in his client's business for years prior to the years that he worked on the account, and I think he is qualified to express an opinion on the statistics of what the workpapers reveal.

I will overrule the objection.

By the Witness:

A. Well, as the summary indicates, each year there is a decline in net sales. Beginning after 1964, 1965, and so on, there is a decline each year in the amount of the domestic sales. Commencing in 1965, the percentage of gross income declines for each year through 1970.

Also, from 1966 through 1971, the domestic operation shows a loss before income taxes when you exclude the dividends from the foreign subsidiaries in 1966 and 1971.

So that there is a downhill trend that is exhibited by this summary.

And to the question that you posed about an excessive write off for excessive inventory, this schedule, I would think—or I think—indicates [165] that the write off in '64 was not excessive because of the continued decline in the gross profit percentage through all of the years.

If the write off in '64 was not excessive, I would assume that the items that were written down too much were sold and would be reflected as gross profit at the gross income line here.

And there would be a more constant—a steady gross profit or possibly an increase, whereas in this schedule there is a steady decrease throughout all of the years.

By Mr. Berens:

Q. Mr. Besant, you said "if it were not excessive."

Did you mean to say "if it were excessive"—the provision?

A. If the '64 provision were excessive, you would expect to see, I think, a different pattern in the gross profit percentage. You would not expect to see a steady decline. If the write off was excessive, it would only be excessive if the items were being sold, and there is no indication of that pattern in this exhibit.

* * *

[168] *Cross Examination by Mr. Sherman.*

Q. Mr. Besant, I would just like you to tell me if you agree with the following statement which represents the definition of commercial accounting practices: "It has been stated that the primary function of commercial accounting is the extraction and presentation of the essence of the financial experience of businesses so that the decisions effecting the present and future may be taken in light of the past."

Would you generally agree with that statement?

A. Let me hear that last line again about the present and future and past.

(Whereupon, the record was read.)

By Mr. Sherman:

Q. I am sorry.

Did you say you would agree or disagree?

A. I can't say it is harmful.

Q. Would you generally agree with that? Is it a reasonably accurate statement?

A. I will agree.

Q. Would you also agree with the following statement: "As opposed to this rather broad function [169] for commercial accounting, the purpose of tax accounting is limited to providing an income figure on which to compute tax."

Mr. Berens: Objection, Your Honor; this witness has not been established as an expert in tax accounting, and I believe it is also beyond the scope of direct examination.

Mr. Sherman: Might I ask the witness one question which would perhaps clarify this, and if it does not, I will withdraw the question.

Can I pass this question for a moment?

The Court: Very well. Ask the question and see.

By Mr. Sherman:

Q. Mr. Besant, have you testified, then, in terms of normally accepted commercial accounting practices?

A. I have testified in accordance with generally accepted accounting principles.

Q. Is it generally accepted accounting principles for businessmen or business organizations to set up many different types of reserves on their books and records in addition to a bad debt reserve, other than bad debt reserves?

A. Yes, it is a general practice.

[170] Q. Is it sound accounting practice to treat as an expense the cost of issuing a stock dividend?

A. The cost of issuing a stock dividend?

Q. Yes. The taxes and mailing costs and all of the costs incurred in the issuing of a stock dividend.

Would that be considered an expense within the framework of generally accepted accounting practices?

A. I think you see it handled in one of two ways, because of materiality. Typically, in some instances, it is charged to capital surplus of the capital stock account, and in some cases it is charged to operations.

Generally, the amounts involved are not very significant.

Q. But such expenses, then, is consistent with sound accounting principles and charged as current expenses?

A. In the materiality phrase, right.

Q. What does that refer to, the "materiality phrase"?

A. Well, we have our generally accepted accounting principles and the variances from those principles are judged by the CPA in the light of materiality. There is no black and white

definition I can give you [171] as to what percentage of net sales or net income is material.

It depends on all of the particular facts and in the particular case.

Q. Let's assume that an automobile dealer is discounting his commercial paper with a bank with recourse—

Mr. Berens: Your Honor, unless Counsel can make it more clear how that relates to the direct examination of the witness, I would have to object again.

Mr. Sherman: I have not finished the question.

The Court: Why don't you finish the question?

Mr. Sherman: This is a hypothetical, Your Honor, and I think at the close of the question we will really know whether it is objectionable or not.

By Mr. Sherman:

Q. Let's assume an automobile dealer discounts commercial paper with a bank with recourse. The bank establishes a reserve out of the amounts otherwise due the dealer, which the dealer cannot receive.

This reserve would be used to take care of the dealer's responsibility in defaults and possessions [172] and so forth.

Would it be consistent with sound accounting principles for the dealer not to consider the amount of this reserve as part of his income?

Mr. Berens: I would like to renew my slightly premature objection.

The Court: On what grounds?

Mr. Berens: On the grounds it is beyond the scope of direct examination and probably is irrelevant, though I can't tell yet.

The Court: I will overrule the objection. I think he is testing the witness—as I can see it—on what generally accepted accounting principles are, and I think he is entitled to do that.

By the Witness:

A. I am not sure I followed all of that. The bank has a reserve?

By Mr. Sherman:

Q. Right. It is a dealer reserve situation, and I assume you have come across that before?

A. I have not handled any automobile dealers, just manufacturing companies.

The bank has a reserve that holds back and does not lend the full amount to the automobile dealer?

[173] Q. Does not pay him the full amount of the price of the commercial paper as discounted by the bank, and this part is kept in a reserve which will be held against any sort of default or any sort of liabilities which the dealer may ultimately be subject to because of his remaining obligations under the paper to discount.

Now, strictly from an accounting standpoint, should this reserve be considered currently income to the dealer?

A. I don't see how it is income if it is—it all becomes involved, I would think, in the overall evaluation of the receivables.

Q. And it is not currently income in terms of generally accepted accounting principles?

Would that be your answer?

A. I believe so.

Mr. Sherman: I have no further questions, Your Honor.

Mr. Berens: I have no further questions on redirect, Your Honor.

The Court: Very well. You may be excused, Mr. Besant.

* * *

[23 June 1972]

[177] ROBERT M. TRUEBLOOD, was called as a witness on behalf of the petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated please and state your name and address for the record.

The Witness: My name is Robert M. Trueblood, 190 Thackery Lane, Northfield, Illinois.

Direct Examination by Mr. Abrams.

Q. What is your occupation, Mr. Trueblood?

[178] A. I am a CPA in public practice.

Q. How long have you been an accountant?

A. I have been in accounting since 1937.

Q. What is your present position?

A. My present position is Chairman of the Board of Directors of Touche Ross & Company.

Q. And that is a public accounting firm?

A. That is a public accounting firm, national and international.

Q. How many accountants are employed by that firm?

A. In the United States, I would say about 4,000.

Q. You have been Chairman since when?

A. I have been Chairman for—Chairman of the Board for 9 or 10 years.

Q. What offices have you held in the American Institute of Certified Public Accountants?

A. In the American Institute, I have been a vice president, a member of council, which is our legislative body, and I was president of the American Institute of CPAs in the years '65, '66.

Q. Which of the major committees and Board of Directors of the AICPA have you been a member of?

A. I was Chairman of the Long Range Objectives [179] Committee of the American Institute, whose purpose was to plan and plot the future of the profession, as it were. I was a member of the APB, the Accounting Principles Board, for a couple of years. I was Chairman of the International Study Group of the Institute, which included representation from about 6 countries to examine into standards of practice of the various countries in an effort towards coordination. I am presently Chairman of the Commission on the Objectives of Accounting, the purpose of which is to formulate, if we can, the broad purposes and objectives of the accounting process and the resulting financial statements.

Q. What was the function—what is the function of the Accounting Principles Board?

A. The Accounting Principles Board was and is that body of the Institute whose responsibility it is to determine the applicable standards and principles for the practice of accounting by the profession in the United States.

Q. In your practice of accounting, have you devoted substantial time to accounting for manufacturing companies?

A. Yes, I have. A large part of our practice is in the manufacturing area.

[180] Q. And your personal experience has been in that area also?

A. I have had personal experience in the area in the sense of being in the field as a junior accountant and running on up through management of jobs in the manufacturing area.

Presently in my role as Chairman of the Board I do not have client responsibility, but those particular problems of difficulty or complexity come to me for discussion, decision, resolution and naturally enough, considering our practice, that includes a large number of manufacturing problems.

Q. In preparing financial statements for a manufacturing company, what goals do you seek to achieve in valuing assets?

A. In valuing assets, the goal given a going concern assumption which overlays or underlies all financial statements, our purpose is to state assets in such a way that there is a reasonable expectation of the realizability of the valuations included in those assets.

Q. What goals do you seek to accomplish in income-statement accounting?

A. In income-statement accounting we attempt to match revenues and costs, all of which have a [181] relationship to the asset valuations we spoke about previously, in such a way that the net income for the period involved is truly reflective of the economic or financial gain or loss for that period, which means that we must consider in effect separately those items of income which are properly realized and therefore reportable in the period involved.

Similarly, we must search out for those costs which properly relate to the realization of the revenues which have been reported, the residual being the net income or loss as the case may be.

Q. How are those principles applied to accounting for inventories in the case of a manufacturing company?

A. In the case of a manufacturing company, typically inventory is the most important asset, maybe not the largest, but the most important asset. And in terms of income determination, the beginning and ending inventories are similarly one of the most important ingredients of the income determination.

Q. In particular, what significance does the inventory valuation have with respect to the income statement?

A. Well, income statement starts out with sales. One must determine the cost of goods sold which relates [182] to those sales. The beginning and ending inventory are significant factors in the determination of the cost of sales.

Q. If the closing inventory is overstated in a particular year, what effect does that have on the net income?

A. If the closing inventory in a particular year is overstated, then income is overstated.

Q. And conversely?

A. And conversely.

Q. In accounting for inventories for a manufacturing company on the basis of a lower of cost or market, what procedures are followed generally?

A. Well, in determining lower of cost or market—did you say what procedures are followed?

Q. Generally.

A. The underlying rules and regulations come out of the literature of the Accounting Principles Board and its predecessor the Accounting Procedures Committee. The controlling regulations which all of us must follow were originally stated, I think, in Opinion No. 6, then codified in No. 43 and are still, in effect, without significant or substantial change.

In looking at cost or market, the cost is, I might say, given, it is not always that easily [183] determinable, but the rule requires if cost is not going to be recovered, then there must be a restatement or a devaluation, as it were, of the inventory to what might simply be called the net realizable value. The technical rules are a little more complicated than that, but the purpose we are trying to achieve is to get that inventory down, as I stated, in times of asset formulation to a reasonably realizable net value in the normal course of business.

Q. A net realizable value will be equated with market for these firms?

A. That is fair enough.

Q. You referred, Mr. Trueblood, to the rules and regulations which the profession has, and particularly to what you described as No. 43. Would you clarify that for us, please?

A. Well, going way back to the 30's, we had what I think was called the Accounting Procedures Committee. The bible, as it were, on inventory evaluation was Bulletin No. 6. Then in the course of the development of these rules and regulations, all then [extant] and still continuing bulletins were combined into what was called Accounting Research Bulletin No. 43. It was sort

of a codification of pre-existing rules and regulations, and it is still in effect and [184] has been adopted by the now Accounting Principles Board as the official statement of the Institute on inventory matters. Forty-three includes a lot of things, but it includes explicitly this matter of inventory.

Q. And the provisions in 43 with respect to inventory are mandatory within the profession?

A. By resolution of council of the American Institute, which is our legislative body, all members of the American Institute must comply with the rules or literature of the Accounting Principles Board. If they depart, they must disclose their departure. And further than that, in such departure they must indicate that they have relied upon substantial authoritative support and defend any departure in those terms.

So, as a practical matter—In fact, I know of no single case in which a report has come out in which it is said that we have departed from these rules in reliance of other substantial authorities for support. So, as a practical matter, an annual report, company by company, the rules of the Accounting Principles Board apply across the board and include the S. E. C.

Q. Is it fair to equate Bulletin 43 with generally accepted accounting principles that are used in [185] accounting opinions?

A. Certainly.

Q. What do those principles provide in accounting in terms of excess inventory?

A. Referring specifically to, I believe it to be Chapter 4, the statement is made that if there is any indication of loss of utility in inventory, that an appropriate downward valuation must be made of that inventory in order to accomplish the statement of inventory at a reasonable net realizable value. A loss of utility could include a number of many things. It could be damage to the product, obsolescence, loss of market in the sense that products on hand are greater than a reasonable forward expectation of sales, and all those kinds of things.

That is, if you had a product which costs you a dollar, you typically sell it at a dollar and a quarter and in the economic

sense there is a loss of utility in the sense that you could not reasonably expect to sell it for a dollar and a quarter in the future. Then you have to reduce to the lower of cost or market in order to accomplish a reasonable valuation of inventory.

Q. Now, dealing specifically with the question of excess inventory, that is, inventory that can be [186] sold for a dollar and a quarter in your example, but there is more of it than is reasonably expected to be sold. What is the requirement of the Bulletin 43?

A. Excess inventory—an excess in inventory would be interpreted to be a loss of utility, which would require a downward adjustment under the principles of 43.

Q. Are there any exceptions to the rule?

A. There is a technical, technical ceiling and floor in this write down process, if you care to get into that.

Q. In terms of the level to which you write it down.

A. In terms of the level to which you write it down, there is a ceiling and a floor explicitly stated in Chapter 4, and I can explain that to you if you like.

Q. What is the highest level which you can show that inventory?

A. The highest level that you—

Mr. Sherman: Your Honor, I will object. I believe that Bulletin 43, if the witness is to rely on it, should be in evidence, should be before the Court. It would certainly appear to speak for itself, so that the parties and the Court may determine to what [187] extent the bulletin is being accurately described by this witness.

The Court: Do you have any objection to introducing it into evidence?

Mr. Abrams: No, Your Honor, I don't. I would like to have this witness testify on a much broader basis than just on Bulletin 43. He has indicated that Bulletin 43 is essentially the bible on inventory valuation. I certainly have no objection to offering Bulletin 43 in evidence. I hadn't thought of doing it that way,

since it seems to be a publication, any more than I would offer a [torts] Treatise in evidence perhaps in a personal injury case.

If Mr. Sherman wants me to mark a copy of Bulletin 43 as an exhibit and offer it as such, I will be happy to do so.

The Court: Why don't you offer it in evidence.

Mr. Abrams: I have only excerpts, two chapters here. I take it, Mr. Sherman, you don't want me to mark and offer the entire—I don't know, it's a couple of hundred pages, isn't it?

The Witness: Yes.

Mr. Sherman: I have never seen this.

Mr. Abrams: You have never seen this [188] Bulletin 43? For a moment, Mr. Sherman, I hand you my copies of Chapters 4 and 6 dealing with inventory pricing and contingency reserves. I would be happy to have copies made over the recess and have those two chapters introduced in evidence as—what is our next number?

Mr. Berens: 28.

Mr. Abrams: —as Petitioner's Exhibit 28.

The Court: What chapters are those you referred to?

Mr. Abrams: Chapter 4, dealing with inventory pricing, and Chapter 6, dealing with contingency reserves.

By Mr. Abrams:

Q. Mr. Trueblood, is there an opening section of Bulletin 43 which describes its general purposes?

A. I can't answer that explicitly. It was a codification. I would presume there is a preface as to how it was done, what was deleted and what was included. I cannot answer that specifically, I would refer you to APB Decision No. 6, which incorporates 43 as pre-existing and presently operative literature.

Mr. Abrams: Your Honor, if I may expand the exhibit to include whatever introductory material there is in Bulletin 43 to describe the manner in which [189] it is organized and the purposes which it is to achieve. We are attempting to bring a copy of the whole thing over so Mr. Sherman can look at it and

expand the exhibit any further. We could include any other portion which he wants.

The Court: Very well. I will anticipate you will offer Exhibit 28, certain portions of Bulletin 43, including Chapters 4 and 6 and whatever other chapters to explain the background. Is that correct?

Mr. Abrams: Yes, Your Honor.

The Court: Very well. I will permit the witness to testify with that understanding.

By Mr. Abrams:

Q. Dealing with generally accepted accounting principles, Mr. Trueblood, with respect to excess inventory, there is a ceiling, you said, there is the highest level at which excess inventory can be shown on the balance sheet.

A. The ceiling and the floor relate to the determination of market in general, and generally market as it is used in the phrase "lower of cost or market" refers to replacement cost, whether by purchase or by production, reproduction. The ceiling, as stated in these terms, says that market shall not exceed the net realizable value less reasonable costs to dispose. [190] The floor says that you shall do the same thing except that you may not get it so low that one would realize more than a normal profit margin on the ultimate sale.

Q. Subject to those floor and ceilings you have described, is there an exception to the rule that you have to write down excess inventory?

A. No. It is not an exception, it is a general interpretation of the concept of market. We say that market means replacement value. Then in determining replacement value we have to consider the utility or disutility of the particular inventory item [illegible] what I said or intended to say was that whenever there is a [illegible] of utility of an inventory item, as in the case of excess parts, obsolete parts, damaged parts, then we must go into this lower of cost or market routine.

Q. And if your firm is auditing the financial statement of a company which has excess inventory which that company refuses to write down below its cost, what action would your firm take?

A. If it were a material item, we could not give them a clean opinion.

Q. By a "clean opinion," you mean, Mr. Trueblood, what?

A. An opinion without exception. In our opinion we believe these statements fairly present and so on.

[191] I might go back a little bit, Mr. Abrams, and say as a part of any audit, this is not gratuitous, we would require a determination by a client to our satisfaction that there was not a circumstance of existing excess parts, or if we were, then we would require some kind of write down in order to give a standard opinion.

Q. By standard opinion or clean opinion, you mean one without qualification?

A. One without qualification.

Q. Under generally accepted accounting principles, is it necessary to wait until an item is actually scrapped to write it down as excess?

A. No, in terms of generally accepted accounting principles it is not necessary to wait until it is scrapped. In fact, there are many circumstances in which it is undesirable to precipitate that scrapping. Excess inventory is a case in point in that let us say we are talking about an industry where service is important. Like in household appliances, if something goes wrong you want to call the jobber or the distributor and be able to get a part to make that refrigerator work that morning. Automobiles is another situation where that similar circumstance exists.

So, the manufacturer of the basic product [192] and therefore the manufacturer in most cases of the replacement item is in a difficult management and economic situation in his attempt to determine what, if any parts he should carry over in the event of possible call or need. So, even though one might know or suspect or predict that you have excess in terms of gadget "x", a good manager is frequently indisposed to scrap it indiscriminately less there be an unanticipated need. So, there is generally a delay in these after-market situations in physical scrapping or disposition.

Q. From the point of view of accounting theory, is there any difference in substance between a write down to market or a write off of items that are unsaleable?

A. You mean write off in the sense of just taking it off the books completely?

Q. Yes.

A. Or write down in the sense of setting up a reserve?

Q. Setting up a reserve, that is not the distinction—

A. Write off and write down are really synonymous.

Q. Whether you put them in a reserve or actually [193] take them off the books?

A. Whether you take it off the books or put them in a reserve is really not germane to the issues, or not relevant to the issues. You are accomplishing the same thing. If you then offset the reserve against the reserve and balance sheet, you get the net realized value for reserve purposes.

As a matter of fact, in many instances, for purpose of managerial control and administrative ease, we would recommend the reserve technique as distinguished from direct write off or write down, but this is a matter of mechanical and administrative simplicity rather, there is no principle involved in that.

Q. If you are on the lower of cost or market, you are obligated to write it down to a market level?

A. You are obligated to reduce the value to a market value by whatever technical means.

Q. Is there any distinction theoretically between the write down to a market level and the general concept of cost or market and the write down or write off for obsolete or excess unsaleable items even if you are not on a lower of cost or market?

A. You have to restate that question, Mr. Abrams, or state it again. I'm sorry.

[194] Mr. Abrams: Would you read it back, please.

(Whereupon the record was read.)

By the Witness:

A. Well, for accounting purposes, cost is not an acceptable method. For accounting purposes we must always be at the lower of cost or market. That is a principle without exception including really FIFO, although that gets into a pretty technical method.

In all cases that you mentioned, excess, obsolete or damage, was that the other one, we are talking about recognizing the loss of utility of an inventory initially valued at cost in order to get it down to a valuation which represents net realizable value in the economic sense, economic and financial sense.

By Mr. Abrams:

Q. Is it in accordance with generally accepted accounting principles to determine the amount of an inventory write down for excess by the use of a formula based on anticipated usage? Excuse me, rather than doing it on the basis of an item by item market analysis.

A. It is a very frequent practice in my experience. In the first place, estimates of forward usage [195] are the appropriate means of determining, forward or past usage are the appropriate means of determining whether one has excess stock or whether one does not have excess stock, but as a practical matter and in a multiplicity of items it is almost requisite administratively and in the internal accounting process to use some formula which hopefully achieves a reasonable approximation of what you are at. If a company has fifty or one hundred or two hundred thousand or even more individual items making this kind of calculation on a nut and bolt basis, it just wouldn't get done.

Q. Is it also in accordance with generally accepted accounting principles to compute this formula on the basis of prior usage?

A. Prior usage or forward usage, as I indicated. In terms of history, we probably relied more on past usage than estimates of forward usage. I would say that in certain industries and in certain situations given the computer we are now able to take more advantage of mathematical means of extrapolation with respect to forward usage, expectations of forward usage, I'm sorry.

Q. By "forward usage," you mean predicted usage?

A. Predicted usage for future periods.

[196] Q. So you really just refined the basis for making predictions?

A. That is right.

Q. Prior to your testimony today, have you reviewed the statutory notice of deficiency that was directed to the taxpayer?

A. I did.

Q. And the petition filed by the taxpayer in this Court?

A. I did.

Q. You also reviewed the Answer and the Amended Answer filed by the respondent?

A. I did.

Q. And the reply to the Amended Answer filed by the taxpayer?

A. Yes, sir.

Q. Have you also reviewed the Stipulation of Facts?

A. Yes, sir.

Q. Have you also reviewed the Exhibits 13 through 17 and 19 through 27?

A. Not so fast on that. 13—

Q. 13 you have before you.

A. I have before me. 18, 19, and 20 I have before me.

[197] Q. Let me show you the other exhibits to which I am referring.

A. 22, I have before me.

Q. 14 through 16, and 24 through 27—I'm sorry, 23 through 27 are the spread sheets entitled "Summary of Inventories and Valuation Reserves for the years '64 through '71."

A. For the years '64 through '71.

Q. Have you also reviewed those?

A. I have seen these, I have seen these, yes.

Q. I didn't bring 14 through 16 with me, but they are the same type of documents.

A. Yes, I have seen these for the years '64 through '71.

Q. And Exhibit 17, I believe, shows the dispositions by year of inventory items by Thor. Have you seen that tabulation also?

A. Dispositions by year? I have dispositions by year on 22. I do not recall a separate exhibit.

Q. It was one of the exhibits attached to the stipulation, the last one attached—

A. There are no exhibits on my stipulation, if this is critical.

Q. It is called "Analysis of Dispositions at Aurora and Los Angeles."

[198] A. I guess I have had it, but I haven't studied it.

Q. On the basis of the materials that you have studied, Mr. Trueblood, in your experience—oh, I'm sorry. Have you also reviewed Exhibits 19, 20 and 22 which you have before you?

A. Yes, 19, 20 and 22 I have before me and I have reviewed.

Q. On the basis of the materials that you reviewed and your experience, have you an opinion as to whether Thor was under generally accepted accounting principles obligated to write down its excess inventory in 1964?

A. I would say yes, and I would refer back to the big long exhibit you gave me which analyzed their reserve calculations. The indications of stock in excess of reasonably anticipated usage indicate that some such step had to be taken.

I would also comment in relation to Exhibit 20, looking at the 10 year history of the domestic operations of Thor with sales having reduced by more than 50 per cent in a 10 year span, I

would just intuitively expect that there would be some inventory gyrations or excesses in terms of level of stock or discontinued items or excess items in terms of forward [199] requirements given the significant downward trend in sales. This would be a natural phenomenon in any business.

Q. Have you an opinion as to whether it was in accordance with generally accepted accounting principles for Thor to accomplish its computation of excess through the use of a formula based on prior usage?

A. I think that is quite appropriate, quite common and generally used in my experience in similar industries or circumstances.

Q. Directing your attention, Mr. Trueblood, particularly to Paragraph 8(b) of the Stipulation describing the number of inventory items which Thor had in 1964. What effect does that factor have on your opinion as to the extent to which Thor's use of a formula was in accordance with generally accepted accounting principles?

A. The very fact that there was some 44,000 items in inventory, including 33,000 incidentally of finished parts, would indicate that resort to a formula approach would be requisite in order to get the job done.

Q. And turning to the specific formula which Thor used, as described in Paragraph 9 of the [200] stipulation, that is, Paragraph 9(c).

A. 9(c)?

Q. Yes, page 6 of the Stipulation of Facts.

A. Yes, sir?

Q. Does that formula appear to be consistent with generally accepted accounting principles in that it accords no value to inventory items in excess of two years anticipated usage?

A. The formula described in 9(c) seems to be a reasonable approach to accomplishing the required result of writing down inventories to net realizable value. The test of the approach, of course,—the test of the specific provisions, mathematical provi-

sions of the formula is determined by the result it achieves, but it looks like a reasonable procedure in order to accomplish the principle required.

Q. Directing your attention to Petitioner's Exhibit 19, the summary of tests performed by Arthur Andersen & Company.

A. Yes, sir?

Q. Have you an opinion based on this exhibit as to the reasonableness of the formula used by Thor to compute its excess inventory?

A. The Exhibit 19 indicates that on a rather substantial sampling basis, Arthur Andersen determined [201] that in '70 and '71 the formula produced results which still represented an understatement of the inventory in terms of actual experience.

It is my understanding that the formula in the '70 column relates really to '69, and then the '70 column relates actual experience of '70 to the results of the formula at the end of '69, and the Arthur Andersen tests indicate that even so, the formula had not taken a large enough write down.

Q. So then it was the reserve that was understated rather than the inventory itself?

A. The reserve would be understated if this be correct, the reserve would be understated and the inventory would be nonetheless overstated.

Q. Assuming that the formula described in Paragraph 9(c) was used by Thor, Paragraph 9(c) of the Stipulation of Facts, the formula which we have just referred, assuming that formula was used consistently by Thor in each of the years after 1964, including the years for which Arthur Andersen made the test described in Exhibit 19, have you an opinion as to the reasonableness of that formula over that period?

A. Well, I do have an opinion. This is Exhibit 22?

Q. No, referring only to—

[202] A. Only to 19 still?

Q. 19, considered on the assumption that Thor used through all of the intervening years the same formula.

A. If '70 and '71 are representative of the situation in the prior years, then it is a very reasonable formula, and it seems to have been a reasonable formula and yielded the desirable results even so with some understatement.

Q. By "desirable results," Mr. Trueblood, you mean results in accordance with generally accepted accounting principles?

A. That's right, the reduction of inventory to a net realizable value.

Q. Directing your attention now, Mr. Trueblood, to Petitioner's Exhibit 22.

A. Yes, sir?

Q. Have you an opinion as to the reasonableness of the Thor reserve for excess in computations of credit to that reserve on the basis of this exhibit?

A. I'll take the answer to that question in two pieces. First may I look at the ending reserve of two million one eighty-one, which has been established on the basis of the formula. We just talked about Exhibit 19, where Arthur Andersen for '70 and '71 [203] established that the valuation was reasonable. Projecting or extrapolating that conclusion to similar circumstances at the end of '71, that would be a reasonable result.

I have also made some rough calculations based on the data in Exhibit 22, which indicates that the average provision of excess and obsolete for the 8 years beginning '64 was $755,000 per year. The average dispositions for the 8 years, beginning '64, were 501,000. So, you have a provision of 755,000, 750,000 to compare with actual recorded dispositions of 500,000, and although there is a disparity there, one still has to provide for the presently required two million one eighty-one reserve, because you still presumably got excess parts in that inventory. So, the relationship seems reasonable.

Taking those same figures for 7 years, starting 1965, your average provision is only 350,000, whereas your average dispositions go to 575,000. So, on the 7 year span it was too little.

And may I make one other comment? Typically in a manufacturing situation, dispositions, the recording of dispositions is

difficult because of your junk or your scrap or what have you, and you cannot possibly identify that scrappage with what went into [204] the formula or what went into the reserve. So, typically in a manufacturing situation, recorded dispositions are understated and some of the dispositions which happened in fact tend to get [buried] in the inventory shortage simply because they—you have to have paperwork to record a disposition, and if that paperwork doesn't really work, then your dispositions are apt or will be on the low side.

The Court: Let me interrupt here. That is because the disposition is a physical thing, is that not correct?

The Witness: Yes.

The Court: And a determination of excess inventory is a technique of valuation as distinguished to physical action on the inventory?

The Witness: Right, Your Honor. My point is that you can't get the physical action of disposition recorded unless appropriate paperwork is generated to do the recording, and the way you work—

The Court: Well, these two things really work independently?

The Witness: They work independently of each other, yes, sir.

The Court: I see.

[205] By Mr. Abrams:

Q. Is it appropriate to consider the dispositions in a particular year against the credits to the reserve in the immediately preceding year or should there be a lag?

A. There should be some kind of a lag, because so long as you stock an item you have to make this market determination which gets it down to a reasonable value. So, unless you say that everything I stock at December 31, '72 is going to be or has to be sold in the year '73, you have to look further.

Maybe automobiles is the best example of that. Model year '72 is going to be on the roads very actively for three or four or five years, and it's really going to be on the roads for longer than that, and so long as that automobile is on the road, somebody somewhere has to have replacement or spare parts to take care of the customers. So, you have to look at the inventory over time and the dispositions over time. So, a year by year is not appropriate where the economic utility of the initial product has more than a one year life.

Q. I believe you previously testified, Mr. Trueblood, that the formula adopted by Thor in 1964, utilized by Thor in 1964 for computing its excess [206] inventory was theoretically reasonable in accordance with generally accepted accounting principles on a foresight basis. On the basis of these other exhibits about which you have testified, have you an opinion on a hindsight basis?

A. A hindsight basis looks pretty good to me. I would correct you, if I may, or if it's necessary for the record, that what I said was the formula approach was a reasonable procedure used to accomplish a required principle.

Q. Didn't you also testify, Mr. Trueblood, that the formula, the particular formula insofar as it had a complete write off of items in excess of two years anticipated usage appeared to be reasonably consistent?

A. It appeared to be reasonable or non-reasonable. We must remember in the entire accounting process we are talking about approximations, we are not talking about fine determinations.

Q. Now, Mr. Trueblood, directing your attention to Petitioner's Exhibit 13, entitled "Special Reserve for Excess Inventory Valuation."

A. Yes, sir?

Q. And also Paragraph 10 of the stipulation which states, if I may summarize it, that the credits to the reserve for excess depicted in Exhibit 13 were [207] computed not on the basis of the formula, but on the basis of estimates applied to items as to which the formula could not be applied on the same basis.

Have you an opinion as to the reasonableness and the propriety in accordance with generally accepted accounting prin-

ciples of writing down excess inventory in this fashion even though a formula is also being applied to other parts of the inventory?

A. A formula requires knowledge about usage. The principle about obsolete over stock or what have you applies to all inventory. So, if the items indicated on your Exhibit 13 could not be fitted into the formula because of lack of data, it is completely appropriate to consider them separately. In fact, it would be completely possible or appropriate to take the total inventory and use one formula on a part of it and another formula on part of it, or two different approaches to it. I don't care what procedure you use in order to accomplish the desired principle.

Q. Would it be in accordance with generally accepted accounting principles to describe Thor's manner of accounting for its inventory at the end of 1964 as lower of cost or market?

A. Yes, there's no question in my mind that lower of cost or market would be a proper designation, [208] description.

Q. If your firm had been the auditors for Thor at the end of 1964 and Thor had refused to write down its excess inventory, what action would your firm have taken?

A. As I said before, in all inventory audits we required a determination of the existence or non-existence of excess stock. If there is such excess stock, we require a downward valuation of it, and therefore if Thor had—if these facts are as they are stated in all of these exhibits, if Thor had not taken this action and had we been the auditors, we would have had to give a qualified opinion.

Q. Qualified with respect to the inventories?

A. Qualified with respect to the inventories.

Q. Do generally accepted accounting principles prohibit the use of arbitrary inventory reserves?

A. Yes, that is covered by Chapter 8 in—no. Chapter 6, I think, of 43.

Q. What kind of inventory reserves are prohibited by generally accepted accounting principles?

A. Let's generally categorize them as contingency reserves, very broadly speaking. Some examples might be, let's say you were persuaded that the economy was going to go down and the price level was going to [209] go down and you made an inventory provision for the fact that the price level was going to go down. That would be an inappropriate accounting reserve for inventories or for anything, for that matter.

Let us say that you established some kind of reserve with respect to inventory contemplated to be purchased but not yet purchased. That would be another kind of non-permitted inventory reserve.

Let us say you establish a devaluation reserve to protect yourself against the possibility that you might discontinue some product lines. That would be an inappropriate inventory reserve.

Q. Would you characterize the reserve that Thor applied against its inventory for excess as similar to the type of reserve you have just described?

A. Not in my understanding, no, sir.

Q. How does it differ from that type?

A. As the Thor inventory reserve was dealing with explicit products on hand, products in the sales market or at least available for sale were dealing with a history of past usage from which they in effect extrapolated the possibility of future sale. So, in no way does that formula—in no way is that formula analogous to the general contingency type reserves that I was attempting to explain by example.

[210] Q. Do generally accepted accounting principles and terminology distinguish between on the one hand a change in accounting principles and on the other hand a change in accounting procedure?

A. Yes, they do. The principle is the broad overriding criterion or criteria. The procedures are the mechanics by which you accomplish those principles. What we have been talking about, the valuation of the inventory at the lower of cost or market, is the principle. The formula, the detail, the mechanics by which you achieve that valuation is the procedure.

Q. Let me ask you some examples, Mr. Trueblood. Would you describe a change from the cash receipts and disbursements basis to the accrual basis as a change in principle or a change in procedure?

A. A change from cash to accrual is a change in principle.

Q. Or vice versa?

A. Or vice versa.

Q. A change from LIFO to FIFO inventory or vice versa, is that a change in principle or procedure?

A. That is a change in principle.

Q. Or in accounting for long term contracts, a change from the percentage of completion basis to the [211] completed contract basis or vice versa?

A. That is a change in principle. A change from completion to completed contract or the other way around is a change in principle.

Q. Or a change in accelerated depreciation to straight line depreciation or vice versa?

A. Or vice versa on depreciation, a change from accelerated to straight line would be a change in principle.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

A. Changing from individual items to groups of items or the other way around would be a change in procedure.

Q. How about a change in computing the bad debt reserve from an age of account basis to a percentage of sales basis, is that a change in principle or a change in procedure?

A. A change in procedure.

Q. A change in computing inventory quantities by complete count to computing them through use of sampling techniques, a change in principle or procedure?

A. Going from total count to sampling or [212] statistical approaches would be a change in procedure.

Q. A change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours, is that a change in principle or procedure?

A. Labor hours to machine hours?

Q. Yes.

A. That is a change in procedure.

Q. Now, assuming that the only method, the only procedure that Thor used in 1964—I'm sorry, 1963, with respect to its inventory was valuation for excess, the procedure described in Paragraph 6 of the Stipulation.

A. That is 6(a) at the top of the page?

Q. Yes. Assuming that Thor computed a credit on its reserve for excess inventory on that basis and that basis alone in 1963, and that in 1964 Thor computed the credit to its reserve for excess inventory in the manner described in Paragraph 9 and 10 of the stipulation.

A. For simplification, that is changing from the 10 year amortization basis to the 10 year procedure?

Q. Yes.

A. That is a change of procedure, each of which [213] should have accomplished the procedure of lower of cost or market.

Q. But it would not, in your opinion, be a change in accounting principles?

A. It would not.

Mr. Sherman: I will object. The effort is obviously being made here to have the case decided by the witness but not by the Court.

The Court: I didn't hear you.

Mr. Sherman: I said I believe an effort is being made here to have this witness decide this case rather than have the case decided by the Court. The issue as to whether there has been a change in accounting pattern is to be an issue to be decided by the Court.

The Court: I don't agree. I think this witness is testifying strictly from an accounting standpoint.

Mr. Sherman: Oh, I agree, Your Honor, from that standpoint, but I don't believe it is relevant.

The Court: I think whether generally accepted accounting principles are applied to achieve a tax result is still another question. I don't think this witness is in any way invading the province of the Court to decide whether a principle or a procedure or [214] method or whatever tag you put on it is under general accounting principles the same under tax accounting principles.

I have listened to his testimony very carefully and I believe that he is testifying from an accounting standpoint.

Mr. Abrams: Your Honor, may I add to that? Under normal circumstances I would keep quiet, it looks like you are about to overrule an objection, but if I can be a little clearer on what Mr. Sherman's objection was. The legal issue is whether there has been a change in accounting method. I have not asked this witness to express an opinion as to that legal conclusion. I have asked him only as to what the accounting profession distinguishes between changes in principle on the one hand and changes in procedure on the other. We will then argue, of course, as a matter of law that what the accounting profession describes as a change in principle is identical with that which the law describes as a change in accounting method. Obviously that is a matter for brief and not for the witness' concern.

Mr. Sherman: With that understanding, as long as that has been made clear as to the nature of this testimony, I will withdraw my objection.

[215] The Court: Very well.

Mr. Sherman: As long as the record is made clear.

The Court: That is the way I understood the statute. He has testified with respect to distinguishing features between an accounting principle and an accounting procedure. Now, whether he crosses the bridge from one of those to an accounting method

I think is the legal question involved probably, and therefore that, I think, is the way I understand the area of his testimony.

By Mr. Abrams:

Q. So that the record will be clear, Mr. Trueblood, what is your opinion as to distinction between the manner of computation described in Paragraph 6 on the one hand and that described in Paragraph 9 and 10 of the Stipulation on the other? Is that a change in accounting principle or a change in accounting procedure?

A. I said that it was a change in accounting procedure in my opinion. I also said that hopefully each of them would have achieved the overriding principle, the result of lower of cost or market.

Q. Directing your attention specifically to what Thor did in 1964 in the manner of computing its [216] excess inventory. Have you an opinion as to whether Thor acted in accordance with generally accepted accounting principles?

A. It is my opinion that they did on the basis of what I know and have seen and have read.

Mr. Abrams: Your Honor, I have nothing further of Mr. Trueblood with respect to the inventory issue. Would you prefer to have Mr. Sherman cross examine Mr. Trueblood on that issue, or the direct on bad debts by Mr. Berens will be very brief.

Mr. Berens: We can do it either way.

The Court: I will leave it up to Mr. Sherman.

Mr. Berens: I've got about three questions.

Mr. Sherman: Why don't you just ask them?

Direct Examination by Mr. Berens.

Q. Mr. Trueblood, I refer you to Petitioner's Exhibit 18, which describes the bad debt analysis for computing its reserve as of December 31, 1965, and ask you if you are familiar with that exhibit?

A. I have reviewed it.

Q. As a matter of generally accepted accounting principle or procedure or either, is the method they used reasonable in your opinion?

[217] A. That is not an uncommon method. The ultimate result, I mean the ultimate test is whether the reduction of the four million nine to four million six accomplished a net realizable presentation in the statement, in the balance sheet, but the application of percentage factors to an aging of the account is not at all unusual and rather common.

Q. If you would compare this aging method that they used and applying different percentages to it, and I am not asking whether these percentages are reasonable or not, but just the method of aging the accounts and varying different percentages, if you compared that as a matter of general accounting principles to taking a six year average of the bad debt experience of the taxpayer, which method would more likely show an accurate result?

Mr. Sherman: If the Court please, I believe this is—here is a general question now. This is extremely speculative. If you will look at the particular taxpayer, you will almost necessarily get a different result—I believe that the question is highly speculative as to which method would show a more reasonable result.

Mr. Berens: Your Honor, I have asked for his opinion on this matter. The issue before the Court [218] as stated yesterday by Mr. Sherman, is whether the Government's six year moving average is arbitrary or not. I have asked this expert who is qualified in the accounting field to compare out method, our client's method with the method that the Revenue Service would force on the client for tax purposes.

The Court: I will overrule the objection.

By the Witness:

A. First, the technique described on Petitioner's Exhibit 18 I would call a procedure as distinguished from a principle. I would also call a moving average percentage determination a procedure.

Now, in my own experience there is some difficulty with moving averages of past experience in the sense that what we are really trying to do from an accounting point of view is to determine the future realizability of the existence of collectibility of those accounts receivable.

Now, the economy of next year or the next year or the next year might be quite different than the economy of the past five or six or ten years. So, I would prefer frankly to look at the future in terms of existing receivables rather than to arbitrarily apply a past experience ratio, although as we talked about in the case of inventories, one has to consider [219] past experience, but it would appear to me that there was explicit consideration, at least in some of these categories, to the nature and the probable collectability of particular accounts which I prefer to the sheer or straightforward matter of application of past experience.

Q. Do I understand correctly that in your opinion the moving average method overvalues the past and does not take into sufficient consideration current and future events as compared to the aging method?

Mr. Sherman: I object to the leading nature of the question and I ask that the Court in evaluating the answer of the witness take into account the manner in which the question has been asked.

The Court: I will sustain the objection to the question.

By Mr. Berens:

Q. Let me restate the question.

What defect, if any, does the moving average method have?

A. The moving average method may put too much credence or support on past economic or business activities which may or may not be representative of future expectations.

Q. Does it take into account any current or [220] future factors?

A. Strictly applied, it takes into account not future expectations.

Q. In your opinion, does an aging system with specific evaluations take into account present and future factors?

A. Yes, sir.

Mr. Berens: That is all on direct.

The Court: Mr. Sherman.

Mr. Sherman: I just have a couple of questions.

Cross Examination by Mr. Sherman.

Q. Mr. Trueblood, I take it then that you don't think too highly of using the taxpayer's own six year past history with respect to bad debts, am I correct in that, in order to determine the reserve addition? In order to determine the reserve to bad debts, you don't think that the six year prior bad debt history is adequate?

A. It is a useful piece of information, but let us say that we had a portfolio of $100,000,000 of receivables in Client "X", and the past year history had a 2 per cent bad debt experience based on sales of "X", and let us say that we had a single account in [221] that $100,000,000 portfolio which is zero. It would be only by chance that past history gave recognition to that unusually bad account.

Q. In summary, then, you feel that the use of the past bad debt history, given a five or six year period, has some defects, is that correct?

A. I do, and if a client of ours were to use a straight moving average on a retrospective basis, we would require in addition an item by item aging and analysis of the present portfolio.

Q. On the other hand, the use of the one year past history as indicative of future sales is entirely reliable, is that what you also testified to?

A. I testified that typically that is all of the information we had available.

Q. But is it reliable as a projection of future sales?

A. It is typically used as the only available—

Q. I am asking you again, is it reliable?

A. It is not necessarily completely reliable, no, sir.

Q. Can you state it more strongly than that? Isn't one year a pretty poor—

A. I wouldn't say that.

Q. —period in which to use for projections?

[222] Mr. Abrams: Your Honor, I think these questions, although rather argumentative, don't have anything to do with comparison. Words such as "poor"—poor as compared to what?

Mr. Sherman: Your Honor, the witness—

Mr. Abrams: May I finish my objection? Mr. Sherman continually complained about the impropriety about hindsight, you have to use foresight. I would think the Respondent should be in some way compelled to take one tact or the other in the course of his case rather than jumping back and forth on either side. If the hindsight is no good and the foresight is no good, the taxpayers are helpless.

Mr. Sherman: If the Court please, this is cross examination. This witness has testified in favor of a method which takes a one year sales history and projects that, and speaking, I assume, from the other side of his mouth he now says that six years aren't really that reliable as a projection if you are talking about bad debts and his client doesn't want to use the [Black Motor] formula. I would like to know which side the witness would like to come down on.

The Court: I will permit you to test this witness' opinion on these matters. It isn't clear in my mind what you mean when you talk about the one year [223] experience.

Mr. Sherman: The one year usage on the inventory.

The Court: Well, are you equating his opinion on inventory with his opinion on bad debts?

Mr. Sherman: No, what I am asking is if he takes the position that with respect to bad debts, the six year past history is not reliable, but at the same time wishes to take the position with respect to inventory valuation, that using the past sales history of one year is reliable as a projection of future sales.

Mr. Abrams: I have no objection to that question, Your Honor, if that is what Mr. Sherman wants to ask.

The Court: I understand the question now, so you can answer that question.

The Witness: Will you restate the question?

By Mr. Sherman:

Q. Well, I would ask again if the use of a one year past history of sales in order to project future sales is a sufficient period for a liability.

A. Well, Your Honor, I have some difficulty because I don't see the difference.

The Court: I don't understand that question [224] at all now that you are talking about liabilities. We have only been talking about assets in this case, either the asset or the account receivable or the asset of the inventory.

Mr. Sherman: I was talking about reliability. Whether the one year period, the one year past sales history is a reliable basis on which to project future sales value.

The Court: Now you are talking about sales.

Mr. Sherman: That is correct. This was in connection with the inventory issue, the formula that was used in 1964 sales as the basis—

The Court: I don't understand the formula to be based on that. It is based on usage, isn't it?

The Witness: That is right.

Mr. Sherman: I'm sorry. Let me change the question.

By Mr. Sherman:

Q. Do you feel that one year usage is a sufficient testing period to be reliable as a projection of future usage?

A. Now you are confining it simply to one year usage on inventory being reliable as an estimate of forward sales?

Q. That is correct.

[225] A. It is a reasonable approach.

Q. But is it a reliable basis upon which to estimate your future usages?

A. Future usages?

Q. Yes.

A. It is a reasonable basis.

Q. I see. And on the other hand, six years is not, in your opinion, a sufficient period of time or a reliable basis upon which to estimate your future bad debt experience?

A. Mr. Sherman, I don't want to be difficult, but there is a lack of analogy between the two situations, because you first asked—or am I not permitted to say this?

The Court: If you don't answer his question that way, I'm going to ask you a question to explain it.

Mr. Sherman: I won't ask another question, Your Honor. No further questions.

The Court: Mr. Abrams?

Redirect Examination by Mr. Abrams.

Q. Would you explain, Mr. Trueblood, the distinction which you draw between the two situations referred to by Mr. Sherman in his last question?

[226] A. Well, the difficulty I had with it—I may have misunderstood some of the earlier questions. The difficulty I had with it is we are always trying to get to net realizable value, whether it be inventories or whether it be receivables. I understood that the six year average in the receivable situation had to do with an experienced percentage of loss. I wouldn't quarrel with six years as being a reasonable averaging of past experience, six or ten or two or three or what have you, but what I got hung up on is that typically I do not see the validity

of past experience on bad debt losses in relation to forward experience on a presently existing portfolio.

It might be the same, it might be vastly different. This is why I used that, you know, unusually worthless $10,000,000 account. Averages for any period of years in the past might not touch that, and yet from the standpoint of an auditor I've got to get that $10,000,000 down to zero, whatever past experience. Now, maybe I misunderstood.

Q. If in the case of your valuation for excess inventory there were certain specific items similar to this worthless $10,000,000 item in the accounts receivable area, would some special adjustment in addition to the formula be necessary?

[227] A. It would be necessary and quite appropriate.

Q. Is that similar, in your opinion, to the adjustment described in Petitioner's Exhibit 13, that LaGrange Park, referred to there as Speedway?

A. That is Exhibit 13, Speedway and Cincinnati Rubber. That is precisely in point in your last question.

Mr. Abrams: Nothing further of this witness, Your Honor.

Mr. Sherman: Nothing further.

* * *

[229] Mr. Abrams: Petitioner's next witness will be Bertrand J. Belda.

BERTRAND J. BELDA was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, sir. State your name and address for the record.

The Witness: My name is Bertrand J. Belda. I live at 33 Lyman Circle, in Shaker Heights, Ohio.

[230] *Direct Examination by Mr. Abrams.*

Q. What is your profession, Mr. Belda?

A. I am a Certified Public Accountant.

Q. How long have you worked in public accounting?

A. Thirty-one years.

Q. You are now with what accounting firm?

A. The firm of Ernst & Ernst.

Q. In the Cleveland office?

A. Yes, in the national offices, which are in Cleveland.

Q. How long have you been with Ernst & Ernst?

A. Thirty-one years.

Q. What is your present position with Ernst & Ernst?

A. I am partner in charge of management consulting services.

Q. For the entire national organization?

A. For the entire firm.

Q. How long have you held that position?

A. Eight years.

Q. In what areas of the practice of accounting have you specialized in in the bulk of your practicing career?

[231] A. Primarily in management accounting, with particular emphasis on cost accounting, profit planning, budgeting, forecasting, inventory valuation and similar areas pertaining to accounting.

I might add, though, that I have also covered other non-accounting areas in the course of my practice, operations of businesses and the like.

Q. What general principles are considered by accountants in valuing assets for balance sheet purposes?

A. The general principles applicable to the valuation of assets recognize the economic and conceptual values of costs applicable to most of the assets.

I might add a very important modification that in the case of current assets, those that are likely to be realized in the

course of a year or in the course of a business cycle, that a very careful valuation is made of its realizable or economic or utility value as an amendment to or an adjustment to cost.

Q. What general principles do accountants apply in preparing income statements, profit and loss statements?

A. The principle thrust of income accounting [232] is to match realized revenues with the cost of obtaining those revenues. In doing so, however, the accountant is mindful of the effort to attribute to a given period of time an appropriate amount of income, net income, which is the difference between the revenues and the costs and expenses, the appropriate amount that is attributable to all of the actions or lack of actions that might have occurred in the business during that period of time.

The relationship of the income statement to the balance sheet is very important because any asset carried over in the balance sheet which is not realizable in subsequent periods represents a serious charge to subsequent periods, which it does not deserve.

In essence, the income statement should pick up all items of costs which are not appropriately carried forward to future periods.

Q. How do those principles apply particularly to the valuation of inventory?

A. Well, in inventory, the cardinal principle is one that is expressed succinctly as cost or market, whatever is lower. This is consistent with what I just expressed about the modifications of cost when and if there is some indication that utility of the [233] inventory might be impaired in terms of its realization.

Q. In general accounting terminology, how would you define "excess inventories"?

A. Generally I would call it inventory in excess of what can reasonably be expected to be sold in the ordinary course of business.

Q. With any particular reference to price levels?

A. No. As a matter of fact, excess inventory frequently occupies a rather peculiar position. Unlike market adjustments, which may be made in view of some price softness in the market, excess inventories are those which cannot be sold regardless of price.

A typical example is in the retail business, in a department store. Merchandise that might be out of date, out of current vogue is frequently offered at prices less than the original sale price in an effort to move the merchandise, and it usually is successful.

In August, department stores will be selling bathing suits at a fraction of their previous price, and by and large most of those bathing suits will be moved because of the price attraction to the customer.

In the case of excess stocks, however, it doesn't make much difference what price you offer the [234] merchandise at. If there isn't a need for it and a good use for it, no one will buy it. And that is an important distinction I think here to recognize in dealing in the cost or market concept, because I believe in the case of Thor that is what we are talking about.

Q. Could you give an example of an excess situation as distinguished from a bathing suit situation that you described?

A. A typical example is the repair part problem. Manufacturers of units, or products comprised of many components frequently change their model, style to include alternative components or components of different characteristics. When that is done, there is frequently a problem of obsolescence in the existing stocks of components for the old unit. But offsetting that is frequently a need for repair parts, service parts to maintain existing units in the hands of customers.

The repair parts stock needs to be tailored to the expected demand, and very often as components are changed, as models are changed, the existing inventory is not the improper balance to recognize the need for these repair parts.

I might go on and emphasize what I mentioned before. If we think in terms of a 1957 Ford automobile, they continue

to be on the streets and occasionally there is a need for a repair part, but the quantity of those repair parts is likely to decline over the years as the number of those models reduce through junking and other loss of utility, but the company who manufactures that is expected to be able to serve whatever customer needs do arise.

In that connection, anything in excess of what is reasonably expected to be used as a repair part is obviously excess stock and has no value except as possible scrap value.

Q. What do generally accepted accounting principles state as to the proper accounting treatment as to excess inventory?

A. Excess inventory for accounting purposes under generally accepted accounting principles is a category of many different and similar categories which I believe the generally accepted accounting principles refer to as loss of utility. This includes excess stocks, it includes damaged merchandise, it includes obsolete merchandise, it includes, oh, a variety of perhaps imperfect merchandise and so on, all of which are regarded as being important to recognize under the cost or market theory, and also I [236] might add der an old accounting axiom of anticipating no profits, particularly when there is evidence that indicates that there is some doubt about its realizability.

Q. So you have to write it down?

A. Write it down, that is correct.

Q. Do you have to wait until the item is scrapped to write it down when it is in this category?

A. In accounting, the evidence that indicates a lack of utility should be recognized as soon as that circumstance can be identified without regard for any physical disposition of the merchandise.

Q. Would it be proper to wait to write it down until you actually scrap it?

A. Absolutely not. In fact, one of the great hazards in business, especially a manufacturing business, is the risk of carrying inventory which may not be realized.

Q. Are these principles relating to the write down of excess to its net realizable value mandatory or optional?

A. They are mandatory under generally accepted accounting principles.

Q. What would happen if a client of your firm had excess inventory but refused to write it down? [237] What action would your firm take?

A. Well, we would have no alternative but to deny approval of the financial statements. When I say deny that, it would either be an exception and/or a denial of our opinion as to their fair presentation, assuming that it is of some significance.

Q. From the point of view of accounting theory, if a company is accounting for its inventory on lower of cost or market, is there any difference between a write down in market and a write down of obsolete inventory items?

A. The impact in terms of income and the balance sheet are identical, and again they come under the same category of loss of utility, and there isn't any difference, no substantive difference. We categorize these as to causes and reasons for lots of purposes, but the economic and accounting impact is identical.

Q. Is the theory of write down for excess the same as the theory of write down for obsolete?

A. Yes, it is. Both relate again to the loss of utility.

Q. Do generally accepted accounting principles authorize the use of a formula as distinguished from an item by item analysis of formula write down of [238] excess inventory? By "formula," I mean by some reference to prior usage.

A. Oh, I would think, particularly in the excess stock situation, the determination of the quantities which are excessive is one that involves a careful analysis which is fundamentally aimed, the point I tried to make a moment ago, aimed at eliminating from the inventory any value that will not be realized in the future.

In doing so, it is apparent that the future needs to be assessed, an estimate needs to be made of what the prospects are. You might generalize, too, that in any kind of forecasting, a major, a fundamental basis is a knowledge of the history of what has happened in the past. This is true in the weather or in economic phenomena. It is the use of the past experience which gives us a clue as to what is likely to happen in the future.

Accordingly, depending on the kind of merchandise, the kind of company, the seriousness and the like of the situation, the estimate is concerned with determining an approximate quantity that is expected to be sold.

Now, in doing so, that involves a formula of determining the amount of items to be sold, either [239] on the one hand on an item for item basis, and in other cases certain tests, certain types of statistical analysis may in fact give at least equal and sometimes even superior results than an item for item kind of analysis.

In answer, yes, formulas are very common.

Q. Prior to testifying here this afternoon, have you reviewed the statutory notice of deficiency that was filed with respect to Petitioner's 1964 income?

A. Yes, I have.

Q. And the Petition which the taxpayer filed with this Court?

A. Yes, I have.

Q. Have you also looked at the Answer and the Amended Answer in this case?

A. I've seen the Answer, but not the Amended Answer.

Q. Have you seen the Stipulation of Facts?

A. Yes, I have.

Q. Have you seen the exhibits that have been received in evidence in this case?

A. Well, some of them I'm not sure that I have.

Q. The ones in particular, Exhibits 13, 17, 18, 19, 20 and 22.

A. Yes, I have seen those.

[240] Q. And are those the exhibits which you have with you?

A. That is right.

Q. The ones I have furnished you. And you also heard the testimony or some part of the testimony of Mr. Trueblood this morning?

A. Yes, I did.

Q. Have you an opinion as to whether generally accepted accounting principles permitted Thor to write down its excess inventory in 1964?

A. Well, I would go further than that. I would say more than permitted, I think they demanded it from the indications and the information I have been able to obtain.

Q. On the basis of the materials that you have reviewed, to which I have referred, have you an opinion as to the action which you and your firm would have taken if you had been Thor's auditors in 1964 and Thor had refused to write down its excess inventory?

A. I think we would have had a serious problem with regard to the fairness of presentation of the balance sheet and the income statement for that year, and if the company refused to recognize this problem through appropriate accounting adjustments, we would have either taken exception or denied an opinion.

[241] Q. Now, Mr. Belda, directing your attention to Paragraph 8(b) of the Stipulation, which appears on page 5, particularly the facts stipulated therein that in 1964 Thor had 44,000, approximately 44,000 inventory items of which more than 33,000 were finished parts and accessories. Have you an opinion as to whether generally accepted accounting principles permitted Thor to use a formula based on prior usage as a means of determining the amount of the write down for excess inventory?

A. I wonder if you could repeat that question. (Whereupon the record was read.)

By the Witness:

A. To answer that, I would say that the objective and generally accepted accounting principles is to produce a sound inventory value in accordance with those principles. The technique used should be in consonance with, in agreement with that objective.

As a practical matter, I would, with the large number of items involved here, think that a formula approach is probably the only practical means of carrying out that objective. However, I do want to emphasize that I regard that as a technique to achieve a principle as opposed to being a principle.

Q. Directing your attention now, Mr. Belda, to [242] the Stipulation of Facts, Paragraph 9(c) on page 6, the description there of the formula utilized by Thor in 1964 indicates the full value was attributed to inventory items equivalent to one year's anticipated usage, partial value within the second year and no value at all to inventory items to be more than two years anticipated usage.

Does that formula appear, in your opinion, to be consistent with generally accepted accounting principles as far as theoretical reasonableness is concerned?

A. Well, I don't know that reasonableness can be completely theoretical. I would say this kind of formula and the amounts used are consistent with the range of values that I am accustomed to seeing in many companies, particularly those that produce units which involve repair part service as well as one time sales.

I think it is in the area of reasonableness, but I might also add, there is a convention relating to inventory valuations and all current asset items which gives strong emphasis to recognizing those values that can be realized within a year or a normal business cycle. The amounts attributable to that which is in excess of the year is probably a little [243] less—well, results in carrying inventories beyond a year's supply, which is a little unusual, a little less conservative, as I would say that most companies, as a general rule, would consider.

Q. The application of the convention to which you just referred in 1964 by Thor would have then increased the amount of the write down?

A. Yes, yes. If I calculated it correctly, I believe those items in excess of a year's supply constitute about another 37 and a half per cent add on beyond the year's supply. Now, I don't know how significant that is. I have made no calculations of it, but if it were of great significance it could even conceivably produce some balance sheet problems because you have stated as a current asset some inventory that won't be realized for more than a year. Frequently when that is of serious consequence, the classification of that item on the balance sheet is moved from the current asset position to non-current.

Q. Application of the convention of writing down all inventory items in excess of one year's supply in 1964 would have had what effect on Thor's income?

A. It would have reduced its income below that which has been stated.

[244] Q. Now, Mr. Belda, directing your attention to Petitioner's Exhibit 19, The Summary of Test of Reserve for Excess Inventory Conducted by Arthur Anderson & Company.

A. Yes.

Q. What conclusions have you drawn on the basis of this exhibit with respect to the credit to Thor's reserve for excess inventory, assuming that the formula referred to in Paragraph 9(c) of the Stipulation was applied consistently by Thor during each of the years 1964 through 1971?

A. Well, in order to assess this, I took a look at the footnotes, which indicate the basis of the tests that were applied, also at the proportions, and they seem to be reasonable, have some statistical validity.

As I see the application, I note that in both years the reserve appears to have been understated, in the case of 1970 by $36,000, or, if I understand this correctly, the reserve was about 17 per cent less than was required.

The situation was somewhat closer in 1971, but there, too, the indication was that the reserve, based on these tests, was—that a reserve, a write down was needed, but it also indicates, if you [245] extrapolate this and apply it to the rest of the inventory, that it was probably not enough.

Q. The reserve was probably not enough?

A. That's right.

Q. And conversely, the inventory was overstated?

A. That's right. That is on the basis of this information that I have here.

Q. Directing your attention now to Petitioner's Exhibit 20, captioned "Summary of Income Statement, Domestic Consolidation."

A. Yes.

Q. Do you have an opinion on the basis of this exhibit as to the reasonableness of Thor's reserve for excess inventory?

A. Well, I'm not certain that I can draw any significant conclusion, with this possible exception, that in using history to project the future and using the sales figures that I see here and the trend in sales, it appears rather evident that the sales in 1966, for example, were not indicative of '67, in fact they were optimistic, and this is generally true through the entire exhibit. That is one indication that I might draw from this.

The company obviously has been suffering some economic difficulties. Sales are over—let's [246] see, that's a ten year period or less than half what they were for the earlier years. I think possibly this might have contributed to some operating problems which accounts for the production or acquisition of stocks of merchandise in excess of what could be sold. In this case, the prediction was based upon more optimistic results than were actually obtained. Those are observations I would gather from—

Q. Do those factors lead you to the opinion as to whether the reserve at the end of 1964 was higher than it should have been?

A. No. If anything, it would indicate to me that it was possibly a little short of what it might have been. However, I would again emphasize that in developing a formula of this character, I would give some great weight to the opinions of the management and its circumstances, its particular product lines and what is happening to them. But in general, I pointed out that one of the important cornerstones of a forecast is analysis and an understanding of the past, but also that isn't the end of it. I think you need to understand the causes of what happened and to be able to project these into the future. In fact, it is the basis of most management judgments that are made.

Q. Now, Mr. Belda, directing your attention to [247] Petitioner's Exhibit 22, "Reserve for Excess and Obsolete Inventories."

A. Yes.

Q. Have you an opinion on the basis of that exhibit as to the reasonableness of Thor's procedure for computing its reserve for excess inventory?

A. Well, according to these data, I observed that the total provision for the eight years under review here aggregates some $6,000,000. I also observed that the dispositions in the next to last column of obsolete and excess inventories during that same period total $4,000,000. I inquired particularly with regard to the year '64, as there are no dispositions included there, and I understand that information wasn't available about those dispositions. If we exclude the year '64, we find that the provision, if I calculate correctly, was about $2,400,000 against actual dispositions of over $4,000,000. This leads me to conclude with regard to 1964, at least, a substantial reserve and/or write down and/or write off, all of which have no substantive difference, was imperative, that there was indeed excess stock and obsolete merchandise on hand that required adjustment.

Q. Now, Mr. Belda, directing your attention to Petitioner's Exhibit 17, described as "Analysis of [248] Dispositions at Aurora and Los Angeles."

A. Yes.

Q. Have you an opinion on the basis of the data shown therein as to the reasonableness of Thor's write down for excess inventory in 1964?

A. Well, it's quite evident, if I read this correctly, and the summary, that the amounts of 1964 reserve and/or write down in the amount of 847,000, approximately, for these two units was subsequently disposed of or, as this indicates, three-quarters or 78 per cent were subsequently disposed of as being obsolete.

Just kind of looking back indicates from the evidence here that at least 78 per cent of that reserve was necessary by subsequent events, but I am also quite aware of the fact that the difficulty of identifying many thousands of parts and its subsequent disposition, such that under ordinary circumstances that the identified amount is probably not all.

Q. Mr. Belda, let me direct your attention specifically to the Summary Line 2, which states that the $847,000 to which you referred applied to Los Angeles and Aurora and the branches, whereas the dispositions referred to in Line 3—

A. Oh, excuse me.

[249] Q. —are only from Los Angeles and Aurora. Does that fact alter your opinion?

A. Yes, I didn't note that. To whatever extent branch data is included in the 847,000, the dispositions would account for a higher percentage of the write off.

Q. And that would have what effect on your opinion as to the reasonableness of the 1964 inventory?

A. Greater support for the need for the write off, or write down or reserve.

Q. And for the reasonableness of the amount of the write down?

A. Yes, yes.

Q. It has been suggested, Mr. Belda, that you may have referred in your explanation of your opinion on the basis

of this exhibit to obsolete. You do understand that this is the tabulation of only excess inventory and not obsolete, Exhibit 17?

A. Since you so inform me, all right. It isn't labeled, I guess.

Q. Will you assume that it is excess?

A. Yes.

Q. I think we will have no problem with Mr. Sherman. It was stipulated to on the basis of being an exhibit relating to excess.

[250] A. All right.

Q. Now, Mr. Belda, I direct your attention to Paragraph 10 of the stipulation, beginning at the bottom of Page 6 and continuing on to Page 7, which describes a supplemental procedure that was used for the write down for excess on various inventory items as to which the formula could not be accurately applied, and to Exhibit 13, which tabulates the amount of the write down of $160,000 that resulted from the adjustments described in Paragraph 10 of the stipulation.

A. Yes, I have that.

Q. On the basis of your experience, have you an opinion as to whether generally accepted accounting principles permit the application of or the utilization of such an additional write down, even though the company in question is applying a formula write down for excess as to the bulk of its inventory?

A. Well, as I understand it, this portion of the inventory did not lend itself to the application of the formula. By that, from information I have, the usage with regard to the Speedway and Cincinnati Rubber portions were not available.

However, in connection with the company's entire operation, the specific evidence developed in [251] terms of usage data for the rest of the inventory would cause me to be concerned about this other portion, and it would lead me to question whether or not, or to question whether, if you will, the same kind of problem existed here.

If the indications were that a similar situation existed, the fact that I didn't have specific data would certainly not alleviate the need to recognize prospective, or existing, I should say, loss of utilization which needed to be recognized.

In looking over the portions ascribed to the items, and that was, I imagine, reserved or stipulated as reserved, these seem to be nominal amounts, with the exception of the hardware portions. When I saw the 50 per cent figure, I inquired of the company management and was advised that the reason for that was that much of the hardware could not be identified with particular part numbers and the like.

In effect, apparently it was a kind of inventory that really had—whether or not it had use was perhaps second to the fundamental operating problem that they couldn't identify where it might be used, and in a large company with many parts, unless you have that information, even if the stuff is in stock, you don't know where it is usable.

[252] So, accordingly, that 50 per cent figure seems to be justified in this case with that added explanation. The others are rather nominal amounts and I would have little doubt but that they were necessary.

Q. And in your opinion appropriate, even though a formula was being applied elsewhere in the inventory?

A. That's right.

Q. On the basis of generally accepted accounting principles and terminology, Mr. Belda, can it appropriately be said that what Thor did in accounting for its inventory at the end of 1964 was lower of cost or market inventory accounting?

A. Yes, and that conforms to generally accepted accounting principles.

Q. Under that term?

A. Yes.

Q. Do generally accepted accounting principles prohibit the use of certain kinds of reserves against inventory?

A. Only those that might be capricious or contingency or profit equalization kinds of reserves are those that would not be recognized.

There must be a sound, justifiable basis [253] for any write down, whether it is achieved through the use of a reserve or whether it is directed against the item themselves.

Q. Could you give examples of the types of reserves which are not approved by generally accepted accounting principles, inventory reserves?

A. Oh, frequently, or maybe not today because they are not recognized as generally accepted accounting principles, but over the years, years ago it was not unusual for a company in its conservatism to apply round number reserves just in anticipation of potential price changes of certain kinds of shortages of other contingencies which weren't identified or weren't applicable.

Since these kinds of reserves were not identified, the accounting profession found them useless in the sense that they could not be restored to income and/or increased based upon some kind of evidential justification, so contingency reserves generally became unacceptable as a generally accepted accounting principle, not accepted, and any kind of such blanket or arbitrary inventory reserves also became unacceptable.

Q. Was the reserve for excess inventory utilized by Thor in 1964 that type of prohibitive [254] reserve?

A. Definitely not. This was determined on the basis of a considerable amount of analysis, particularly with regard to the tools, which, I guess, were the bulk of the inventory.

Q. Even though it related to the contingency of what would or wouldn't be sold in the future?

A. Well, this was existing inventory that evidence clearly indicated could not be sold.

Q. Under these circumstances, is there any difference from the point of view of generally accepted accounting principles between the use of a reserve as a contra account on one hand

or simply writing off the books the inventory that is regarded as excess?

A. Not at all. They both accomplished the identical purpose.

Q. Do generally accepted accounting principles recognize a distinction between a change in accounting principles on the one hand and a change in accounting procedures on the other?

A. Very much so, yes. Principles are seldom changed, but techniques, practices, procedures constantly change in most companies because of changing conditions, circumstances and the like.

[255] Q. Would you characterize a change from the cash receipts and disbursements basis to the accrual basis as a change in principle or a change in procedure?

A. That is a change in principle.

Q. In the case of accounting for long-term contracts, how would you describe a change from the percentage of completion basis to the completed contract basis, a change in principle or a change in procedure?

A. That is a principle change.

Q. How about a change from the LIFO to FIFO inventory or vice versa?

A. That is another change in principle.

Q. Or a change from accelerated depreciation to straight line depreciation or vice versa?

A. Also a change in principle.

Q. A change in computing a bad debt reserve from an age of account basis to a percentage of sale basis, is that a change in principle or a change in procedure?

A. No, that is a technique or a procedural change.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

[256] A. Again, that is a procedural change, which is in both instances aimed at maintaining the same accounting principle.

Q. How about a change from computation of inventory quantities by complete count to computations through use of sampling techniques?

A. Another procedural change.

Q. A change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours?

A. That is a procedural change. Very common, by the way.

Q. Assuming that the only write down for excess which Thor used in 1963 was accomplished in the manner described in Paragraph 6 of the Stipulation of Facts, to which I direct your attention. If that was the only manner in which a write down for excess was computed in 1963, and that in 1964 the write down for excess was computed in the manner described in Paragraphs 9 and 10 of the Stipulation, Paragaph 9(c) being the formula to which we have referred and Paragraph 10 being the additional write down of the $160,000, assuming that in '63 only the Paragraph 6 basis was used and in '64 the other. Would you describe that as a change in accounting principle or [257] a change in accounting procedure?

A. A change in accounting procedure. Here again the principle remains the same, to recognize the deterioration of utility value, which is part of the cost or market.

Q. On the basis of your experience and the factors which you have considered, do you have an opinion as to whether Thor's write down of its inventory as of December 31, 1964 for excess was in accordance with generally accepted accounting principles?

A. Yes, it was.

Mr. Abrams: Your Honor, I have nothing further of this witness with respect to the inventory issue.

If Mr. Sherman has no preference, perhaps we can have Mr. Berens ask a few questions about bad debt reserves before cross-examination on all issues.

The Court: Very well.

Direct Examination by Mr. Berens.

Q. Mr. Belda, have you had a chance to review Petitioner's Exhibit 18?

A. Yes, I have.

Q. Would you describe generally the system used by the Petitioner as evidenced by that exhibit in [258] evaluating its bad debt reserve at the end of 1965?

A. As I understand this exhibit, it is an analysis of the account receivable status at the close of 1965, which considers various categories of the receivables as they stood at the date and their respective collectabilities.

As I gather from this exhibit, the company, through the process of aging its accounts receivable, that is to say, categorized them as to the period of time that the accounts were past due, or not past due—first I should say not past due and then those that were past due—and taking past due as evidence of questionable collectibility, sought to establish appropriate reserves for uncollectible accounts based on that analysis.

I might add that apparently certain of the larger account balances were identified as being substantially all uncollectable, and, as I presume, that was the information about the debtor that the company was able to obtain.

Q. In your opinion, is this method that was used of aging accounts and applying different percentages to the different agings and of evaluating hard core collectability a satisfactory method under generally accepted accounting principles?

[259] A. Yes, it is a satisfactory method.

Q. Would you compare from the standpoint of generally accepted accounting principles that method with the method of taking a six-year moving average for calculating the reserve based on the actual experience during those six years of the particular creditor?

A. Well, I would answer that and say both methods have been used. The moving average method takes cognizance of some history, but the fact that many years, six years are used as opposed to one, two, five or some other number, does not contribute much more validity or reliability, particularly in view of the fact that some of the data is old data.

I would think if I were going to use history alone, I would be more likely to recognize current information or more current information to give it greater weight. However, in certain kinds of establishments, particularly small loan companies with literally millions of accounts, banks among others, it is not unusual to use a moving average experience, and particularly where credit losses are statistically controlled.

However, an analysis of the specific situation with regard to the status of the accounts as they [260] were at the close of the year, as they existed, I think is generally superior to the moving average history, and I would think it is rather evident as to why it is superior simply because it takes far more specificity as to the individual accounts.

As I say, the history and large numbers of accounts is a convenient way. I don't know how many accounts Thor had at the end of 1965, but I would doubt that they were millions in number.

Q. Well, if history is an important factor, would not a history of ten years, or in the case of Thor, which has been in existence for 80 years, wouldn't an 80-year history be better?

A. Well, that is a fallacy. The more ancient history that you inject into these experiences, the less valid it is in terms of current operating practices. The management of Thor 80 years ago was certainly far different than it is currently. I think I can make that statement safely.

Credit policies tend to change with economic conditions, with supply, demand, competition. Credit is an instrument of sales, and credit is tightened on occasions and expanded on other occasions. So, it isn't something that tends to be constant at all, but it changes under prudent management. And the [261] condition of the accounts as they stood at the end of 1965 represented the current status of management decisions and the extension of credit.

If, as indicated here, the accounts over $100, a hundred and sixty-one thousand of that amount, of the total amount, was, as it is called, "hard core," extremely doubtful of collection, it seems to me that that ought to be recognized.

Here again the objective is to avoid carrying forward a receivable which is doubtful of collection.

Q. Under the moving average system, do I understand correctly that if there was only one debtor who was bankrupt, that—I am going to try to rephrase that question. Strike that.

Do I understand correctly that under the moving average system a reserve would be permitted even though the accounts receivable were entirely one creditor who was bankrupt?

A. Using that method, this would be the result, but it would be an obvious inappropriate result.

Q. Let me pose the converse. If there was six years of experience showing a certain amount of uncollectability for various customers, but now this particular company was selling, let us say, to a [262] single customer, General Motors or the United States Government, would it be appropriate on the moving average to apply, by this mechanical method, to apply reserve for bad debts even though it is a single customer whose credit is no question?

A. In that extreme, the obvious answer is that the technique would be inappropriate. Incidentally, one reason why techniques or procedures need to be changed, to adjust to the circumstances as they currently exist. Again, the reason why, this kind of analysis tends to be superior to the statistical variety.

Mr. Berens: No further questions.

Mr. Sherman: No questions, Your Honor.

The Court: Thank you, Mr. Belda.

The Witness: Thank you.

Mr. Abrams: As we have previously advised Your Honor, regrettably, the scheduling has prevented us from going—oh, Mr. Belda.

Mr. Berens: Mr. Belda, would you stay on the stand a moment.

Mr. Abrams: I have technically rested with respect to this witness, Your Honor. May we reopen to ask him a few other questions which were omitted?

The Court: Surely.

[263] *Direct Examination (Resumed) by Mr. Abrams.*

Q. Mr. Belda, has the Division of Federal Taxation of the American Institute of Certified Public Accountants expressed an opinion with respect to the treasury regulations in connection with accounting for excess inventory for tax purposes?

A. Yes, it has.

Q. Are you familiar with the details of that opinion?

A. Yes, I am, quite familiar with it.

Q. Would you state generally what the opinion as expressed is?

A. Yes,—

Mr. Sherman: Objection, Your Honor. I believe now we are getting into the field of the province of the Court. I don't believe that the opinion of any private organization with respect to the issue before the Court, which will have to decide the validity and interpretation of those regulations, can possibly be the subject of expert testimony.

Mr. Abrams: If Your Honor please, first of all, we are not, of course, expecting that the views of the American Institute or of any private organizations are dispositive of any issues before the Court. [264] However, we have here the rather unusual position, the situation that the Internal Revenue Service itself requested comments from the accounting profession with respect to the proposed regulations. The comments were in fact submitted by various private accountants, private individuals or firms, and by the Division of Federal Taxation of the AICPA to the Internal Revenue Service. My understanding is that hearings were to be held in May of this year with respect to the

proposed regulations, but that after receiving certain written comments the Internal Revenue Service itself postponed the hearing.

Mr. Belda, as I will elicit if permitted to go on with him, participated very actively in drafting of the written report which the AICPA Division of Federal Taxation submitted to the Commissioner of Internal Revenue, and indeed Mr Belda is the author of the particular section of that report which we have here and will propose to mark and introduce as a Petitioner's Exhibit, the particular portion dealing with what the regulations should provide with respect to excess inventory.

That is obviously not controlling, dispositive of the issues in this case. I believe it is very relevant as an expression of opinion by the [265] organized accounting profession as to what the regulations should provide.

At the moment the regulations are silent on the question of excess. It is for that reason that I undertake this line of interrogation.

Mr. Sherman: I don't believe, Your Honor, that any reason or any basis for the admissibility of this evidence has been stated.

We are still dealing with a question of law. There are many regulations with respect to which hearings are held, there are many verbose changes in the regulations, and anyone, any individual, any organization is free to render their opinion, to send in a written opinion with respect to their views as to how the regulations should be changed or whether the regulations should or should not be changed or whether a particular proposed regulation should or should not be adopted.

It appears to me that if the door is opened to this sort of thing, then it could be opened to just about anything.

We could have a million letters, because a million people chose to send in an opinion with respect to proposed regulations.

Mr. Abrams: In this case, Your Honor, [266] however, the regulations as they stand talk about the best accounting method

that most clearly reflects the taxpayer's income. In our view of the case, which I understand to be different than Mr. Sherman's, the concepts of generally accepted accounting principles and the view of the accounting profession are exceptionally relevant.

We have present and available for cross examination the man who wrote the position that was adopted by the AICPA Division of Federal Taxation and submitted it to the Internal Revenue. Again it is not dispositive of questions of law which face Your Honor, but we believe it is certainly relevant for Your Honor's determination of what best accounting, generally accepted accounting principles are in this situation and what methods of accounting best and most clearly reflect the taxpayer's income.

It is for that reason that we seek to introduce the views of the accounting profession as they have been so adequately expressed through the opinion of this witness.

The Court: Well, since the regulations are silent on the issue before the Court and the views of the American Institute of Certified Public Accountants was solicited by the Treasury Department [267] in proposing regulations in this area, I trust that if the regulations are adopted after the hearings are conducted, that they probably won't be applicable to the years before the Court.

If you will lay the proper foundation with this witness to show his participation in the report, through his testimony rather than just through your representations, I think it should have a material bearing on the issue in this case, because although many views may have been submitted to the Treasury before the hearing, and, of course, I have no knowledge of how many, but I would think the views of the American Institute of Certified Public Accountants would be entitled to great weight, particularly since the regulations in the Code make reference to generally accepted accounting principles.

I offhand know of no body—and I don't mean that in one word, it sounds like a double negative—I don't know of any group of individuals or any organizations that can express an

opinion as to generally accepted accounting principles better than the American Institute of Certified Public Accountants.

So I am going to overrule the Respondent's objection and permit this witness to testify to the contents of that report.

[268] Mr. Berens: Your Honor, for the Court's information, I would like to point out, and I have been looking for the memo and I can't put my hands on it, that the amendment of Treasury regulations is retroactive unless it is detrimental to a taxpayer. So, if these regulations were amended, they may well control the year '64, because it would not be in this case, assuming they were amended as the American Institute proposes, they would not indeed be detrimental to the taxpayer.

Mr. Abrams: I hope they amend it soon.

By Mr. Abrams:

Q. Mr. Belda, rather than asking the reporters to look for the last pending question, did you participate in the drafting of the comments of the Division of Federal Taxation of the American Institute of Certified Public Accountants with respect to proposed regulations regarding valuation of inventories?

A. Yes, I did.

Q. Who is the chairman of the Committee that prepared this report?

A. Robert G. Skinner.

Q. Your relation to Mr. Skinner is what?

A. He is my partner.

[269] Q. Did Mr. Skinner elicit your assistance in the preparation of this report?

A. Yes, he did.

Q. Showing you a document which has been marked for identification as Petitioner's Exhibit 29, I ask you whether this is a copy of the report which the Division of Federal Taxation submitted to the Internal Revenue Service on April 17, 1972.

A. Yes, it is.

Q. Were you personally responsible for writing various portions of this report?

A. Yes, I was. I drafted a substantial portion of this paper. In fact, most of those that relate specifically to valuations as opposed to those relating to technical questions on regulatory changes and methods of adopting the new regulations, which I think are tax administrative matters as opposed to valuation matters.

Q. Have you, on the original of this report, the original of this copy from which this exhibit was Xeroxed, indicated with pencil lines in the margins those portions which you personally drafted?

A. I don't know whether I've got them all, but I think I've got most of them.

Q. But at least those portions which do bear [270] the marks in the margins were drafted by you?

A. Yes. I have pencil marked those lines which I authored.

Q. Directing your attention specifically to Pages 4 and 5, dealing with, and I quote on Page 4:

"The problem of determining appropriate costs for inventory quantities in excess of prospective demand."

A. Yes, sir.

Q. Did you write that section?

A. Yes, I did.

Mr. Abrams: Your Honor, I offer in evidence as Petitioner's Exhibit 29 the document which has just been described.

Mr. Sherman: Respondent objects for the reasons previously stated.

The Court: Very well. The objections are noted and the Exhibit will be received in evidence.

(The document previously marked for identification as Petitioner's Exhibit No. 29 was received into evidence.)

Mr. Abrams: Thank you, Your Honor. I have no further questions of this witness. You may cross. Hopefully I have no further questions of this witness [271] at all.

Mr. Berens: Your Honor, before we—

The Court: Do you wish to cross-examine, Mr. Sherman?

Mr. Sherman: I have no questions, Your Honor.

The Court: Thank you. You may be excused.

* * *

[26 June 1972]

[283] Mr. Abrams: Petitioner's next witness will be Newman T. Halvorson.

NEWMAN T. HALVORSON, was called as a witness on behalf of the petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir, and state your name and address for the record.

The Witness: Newman T. Halvorson, Woodstock Road, Gates Mills, Ohio.

Direct Examination by Mr. Abrams.

Q. What is your profession, Mr. Halvorson?

A. I am an independent public accountant.

Q. How long have you been in public accounting?

A. Since 1930.

Q. With what firms of accountants have you practiced since that time?

A. During all of that time with Ernst & Ernst. From 1930 to 1954 in its Detroit office, and from 1954 until now in its national office in Cleveland.

Q. What were your duties and responsibilities [284] when you were in the Detroit office of Ernst & Ernst?

A. They always had to do with auditing and financial reporting. From 1930 until 1940 as a field auditor, and from 1940 to 1954, primarily as a reviewer of audit working papers

and reports and financial statements that were being issued by clients of ours.

Q. During that latter part in the Detroit office, were you the senior man responsible for reviewing the field auditing of manufacturing audits?

A. In the office I was. In other words, as papers and reports came in from the field to the office, I was the principal reviewer during the last ten or twelve years, yes.

Q. What have your responsibilities been since you went to the national office of Ernst & Ernst in 1954?

A. They have still been connected with auditing and financial reporting, although the amount of field auditing has been minimal, essentially not at all, although I have retained some connections with some clients of the firm in various parts of the country.

Q. What is your overall role now in Ernst & Ernst with respect to auditing and accounting and financial reporting standards?

[285] A. I am called the partner in charge of technical auditing and accounting services, which includes, among other things, primary responsibility for our practice before the Securities and Exchange Commission and published financial reporting generally.

Q. As partner in charge, that means you are in charge for the entire firm of Ernst & Ernst nationally in this respect?

A. In a staff sense, yes, not in a line sense. I do not direct our auditors. I try to answer their questions and try to see that we are maintaining appropriate standards and adhering to appropriate reporting practices.

Q. About how many professionals does Ernst & Ernst employ in the United States, professional accountants?

A. As of now, I believe between four and five thousand.

Q. On what committees of the American Institute of Certified Public Accountants have you served?

A. Beginning about 1955, I was on the Committee on Accounting Procedure, which was the senior committee responsible for accounting principles and accounting theory and so on generally.

[286] It was a group of 21 men, I think, that had that responsibility for our organized profession. It went out of existence in 1959.

Then, after a lapse of about two years I was appointed to the AICPA Committee on Auditing Procedure, which was the senior committee responsible for auditing and reporting practices for the profession.

I served on that committee until 1966, at which time I resigned to accept an appointment to the Accounting Principles Board.

The Accounting Principles Board was created in 1959 to succeed to the old committee on accounting procedure and did become the most authoritative body within the American Institute of CPAs on matters of accounting principles and good financial reporting generally. I am still on that body, on the Accounting Principles Board.

I have also served two one-year non-consecutive terms on the AICPA Committee on Relations with the SEC and the Stock Exchanges, which was more or less a liaison committee between those organizations and the American Institute of CPAs.

Q. About how many members are on the Accounting Principles Board at any given time?

[287] A. For the last several years there have been 18.

Q. In preparing a balance sheet or reviewing balance sheets, what general principles are applied with respect to valuation of assets?

A. The basic presumption is that assets will be stated at cost, historical cost. Then there are some overriding conventions which may suggest that cost on occasion will be reduced in view of surrounding circumstances, but you begin with the premise that cost is the appropriate basis.

Q. And what general factors are considered in asset valuation with respect to the preparation of income or profit and loss statements?

A. Generally speaking, you attempt to anticipate losses as soon as they are evident. You recognize declines in market values in many instances.

If your realizable value or your recoverable value is less than the recorded cost, you try to look at the utility of an asset and recognize diminution in value, if its utility has declined or deteriorated.

Other costs you spread around among the periods of usefulness, such as depreciation of plant and amortization of various types of deferred costs and so on.

[288] Q. How do you apply those principles to accounting for inventory?

A. Again you begin with the basic presumption of cost, but there is a rule of lower of cost or market, which is an inescapable rule which suggests—that demands that at any time at which an inventory has declined in value or in usefulness below cost, you will write it down to what we call market, and market may be replacement cost if you can replace the item at less than it cost initially, or you may have to write it down to realizable value.

In case the proceeds that you expect to enjoy from its disposal are not enough to recover the cost, a reduction of market will be obligatory.

Q. Under generally accepted accounting principles, what is the appropriate treatment of excess inventory?

A. Well, excess inventory will be considered inventory which you will not be able to dispose of in the ordinary course of events at a price sufficient to recover the cost you have in it, so it will be written down to what I would consider to be its market price, which may be a scrap value in extreme cases. It may be a reduced selling price in other cases.

It may be an effort to price it at an amount [289] which will be not greater than the net realizable value of the item or items.

Q. Do you have to wait until an item is physically scrapped before writing it down as excess?

A. Not at all. I think we have in practice regularly and frequently instances where excess stocks are being reduced to let us call it anticipated, realizable amounts without the physical scrapping occurring.

Q. Is the principle relating to writing down excessive inventory an optional one or is it mandatory?

A. It is mandatory.

Q. What would happen if your firm were auditing the financial statement of a manufacturing company which refused to write down its excess inventory? What action would your firm take?

A. We would have to issue a qualified opinion saying that we did not believe the financial statements presented the financial position and results of operations to conform with generally accepted accounting principles. Depending on the extremity of the difference, we might have to go so far as to express an adverse opinion or even disclaim an opinion, but in any event, it would be a qualified opinion. [290] We could not say we had a fair presentation.

Q. In the case of a company which is accounting for its inventory on the lower of cost or market, is there any substantive difference between a write down to market and a write down of obsolete inventory items?

A. From an accounting point of view, no.

Q. Is there any theoretical difference between a write down to market for excess or a write off of unsaleable items which are obsolete?

A. I don't think so.

Q. Do generally acceptable accounting principles permit the use of a formula based on prior usage as a means of writing down excess inventory?

A. The accounting principle runs to the value established for inventory. The formula could be a thoroughly acceptable

accounting procedure or auditing procedure for arriving at this market value.

Q. Under what circumstances would generally accepted accounting principles permit the use of such a formula?

A. Typically where you have a vast aggregate of separate descriptions of inventory, no one of which maybe is extremely large individually, but collectively they are important, and the sheer [291] mechanics of trying to arrive at individual evaluation of every specific inventory item or description makes it almost prohibitive, so you arrive at a formula approach that can be applied effectively and expeditiously and arrive at what would be essentially the same desired end.

Q. Can you use a formula which is based on prior usage as a means of estimating future usage?

A. Oftentimes it is based on prior usage. Sometimes a formula will be based upon the age of the item. The effect, however, would be similar, and based on usage would be a typical instance. Based on prior usage would be a typical instance.

Q. Have you in your experience observed companies which you were auditing using formulas for writing down excess inventory?

A. Yes.

Q. And have you regarded this as in accordance with generally accepted accounting principles?

A. Completely.

Q. Prior to your testimony here this morning, have you reviewed the Statutory Notice of Deficiency which was submitted to the taxpayer in this case?

A. Yes.

Q. Have you also reviewed the Petition which [292] the taxpayer filed in this Court?

A. Yes.

Q. And the Answer which the Respondent filed to that Petition?

A. Yes.

Q. Have you also reviewed the Stipulation of Facts?

A. Yes.

Q. And have you reviewed Exhibits 13 through 27? That is, 13, 17 and 18 I think you have before you. 14 through 16 and 23 through 28 are the spread sheets, Mr. Halvorson.

Let me show you an example of Petitioner's Exhibit 23, which is entitled Summary of Inventories and Valuation Reserves. This one, Exhibit 23, is as of November 30, 1967.

A. I have seen them.

Q. The other ones—

A. For five years, on through 1971.

Q. Yes.

A. I have seen them. In response to your question, Exhibits 13, 17, 18, 19, 20 and 22, I guess it is, yes, I have reviewed them.

Q. And 14 through 16 and 23 through 28, Mr. Halvorson, are the spread sheets for each of the years?

A. That's right.

[293] Q. I am sorry. I am told it is through 27, not through 28.

Based on your review of those materials and your general experience, Mr. Halvorson, have you an opinion as to whether generally acceptable accounting principles permitted Thor to write down its excess inventory in 1964?

A. Yes.

Q. What is your opinion?

A. That Thor was not only justified but in retrospect I think would have been compelled to make a provision for excess stocks in 1964.

Q. If you had been the authorized auditor at that time and Thor had refused to write down its excess inventory, what action would you have taken?

A. We would have qualified our opinion on the financial statement as being not in conformity with generally accepted accounting principles.

Q. Mr. Halvorson, directing your attention now to the Stipulation of Facts, and in particular Page 5 thereof, Paragraph 8(b) in the middle of that page describes the number of inventory items that Thor had at the end of 1964 as being 44,092 items.

Considering that fact, have you an opinion as to whether generally accepted accounting principles [294] permitted Thor to use a formula as a means of determining the amounts of write down for excess?

A. I think a formula was permissible and desirable.

Q. I'm directing your attention now, Mr. Halvorson, to Paragraph 9(c) of the Stipulation, which describes the particular formula which Thor used in 1964 to write down its inventory for excess. That is a formula which afforded no inventory value to items in excess of two years of anticipated usage.

Have you an opinion as to whether that formula appears, just the formula alone, to be consistent with generally accepted accounting principles?

A. I think the formula just looked at alone would be consistent with generally accepted accounting principles.

The specific nature of the formula would be a judgmental thing, but as a formula, it would be acceptable to me.

Q. Does it appear to be generally consistent with formulas that you have observed in the course of your experience as being used by other companies?

A. It would have the same general thrust or import, yes.

Q. Now, Mr. Halvorson, directing your attention [295] particularly to Petitioner's Exhibit 19, which is the Summary of Tests of Reserve for Excess Inventory prepared by Arthur Andersen and Company, and assuming that throughout each of the years after 1964 through and including 1971, Thor wrote down its excess inventory using the formula that is described in Paragraph 9(c) of the Stipulation, have you any opinions, have you formed any conclusions on the basis of this exhibit, as to

the reasonableness of the procedures which Thor followed for writing down its excess inventory in 1964?

A. Yes, I have.

Q. What is your opinion?

A. Exhibit 19 would suggest that the formula was accomplishing its intended purpose and possibly was creating less of a reserve than might be required based upon actual experience; that the provisions being made were something less than the requirements demanded.

Q. Directing your attention now, Mr. Halvorson, to Petitioner's Exhibit 20, the Summary of Income Statement Domestic Consolidation for the period of 1962 through 1971, have you an opinion, on the basis of this exhibit, as to the reasonableness of the write down for the excess inventory which occurred at [296] Thor at the end of 1964?

A. Looking at the trend of Thor's sales from 1964 on through 1971, which show a steady decline year-by-year, it would suggest to me that an estimate of usage on which a formula is predicated would probably result in a reserve that may be even less than necessary because usage estimated in one year, in the face of what appears to be declining sales will probably turn out to be less than actual usage and at the same time the progressively declining sales would suggest that the accumulation of excess stocks may continue, that production in one year may prove to be greater than requirements, so that the condition for which the formula reserve is provided would be a continuing one.

Q. Now, Mr. Halvorson, directing your attention to Petitioner's Exhibit 22, captioned Reserve for Excess and Obsolete Inventory Domestic Consolidation—

A. I have it.

Q. Have you an opinion on the basis of this exhibit and the data shown therein, as to the reasonableness of Thor's write down for excess inventory at the end of 1964?

A. Yes, I do.

Q. What is that opinion?

[297] A. Again it is my opinion that the reserve, the provisions to the reserve would be, appear to be reasonable year by year.

There have been significant disposals of excess stock, but the condition demanding continuing additions to the reserves had not disappeared.

The dispositions are those, as I understand it, which were actually identified and accounted for as being dispositions of excess stock in the inventory at the end of 1964.

The probabilities are that the actual dispositions, either by scrapping or failure to maintain the necessary records for precise accounting for disposals, would result in a condition where the actual disposals will have been greater than the ones recorded as such.

Q. Now, Mr. Halvorson, directing your attention to Petitioner's Exhibit 17 which is captioned Analysis of Dispositions at Aurora and Los Angeles—

A. Yes.

Q. Have you an opinion on the basis of the data shown in this exhibit as to the reasonableness of Thor's 1964 write down for excess inventory?

A. Yes, I do. This exhibit shows in the summary at the end of it that the reserve created in [298] 1964 in the amount of $1,000,000, $1,079,000 included $846,000 attributed to inventory at three locations, Los Angeles, Aurora and branches, thinking of branches as being a single location; whereas in the years since that reserve was created, the dispositions from the Los Angeles and Aurora locations alone without regard to what may have been occurring at the branches, amounted to $657,000.

So that it seems to me that when dispositions to date have accounted for something like 78 per cent of the reserve provided, that the need for the reserve is quite clearly demonstrated and the amount of it seems to be quite consonant with the demand.

Q. Now, Mr. Halvorson, would you direct your attention to Paragraph 10 of the Stipulation, beginning at the bottom of Page 6 and going over to the top of Page 7, and also after you have looked at that would you look please at Petitioner's Exhibit 13.

Both Paragraph 10 of the Stipulation and Petitioner's Exhibit 13 relate to credits to the reserve for excess inventory valuation in the amount of $160,000, which were computed on a basis other than the formula described in Paragraph 9 of the Stipulation.

A. Yes.

[299] Q. Do generally accepted accounting principles permit such additional write downs even though a company is using a formula for writing down excess inventory as to parts of its inventory?

A. Yes.

Q. Under what circumstances?

A. A corporation, a manufacturer or any other business may use different procedures for arriving at inventory valuations for different parts of its inventory.

If the appropriate records for applying the formula are not available, the manufacturer or the business would have to turn to some other method, to some other procedure for arriving at similar valuation and the application of percentages to inventory categories as was done in this instance is completely sound accounting, completely appropriate procedure.

Actually a procedure such as this could have been superimposed on a formula. If indications were that the formula might not be accomplishing all it was designed to do, one might still go into an overriding percentage determination.

That is not what was done here, but I say it would be acceptable, permissible and sometimes may be necessary.

[300] Q. Under generally accepted accounting principles, would it be appropriate to characterize Thor's manner of accounting for its inventory at the end of 1964 as lower of cost or market?

A. I think that is what it was, yes.

Q. Do generally accepted accounting principles prohibit the use of certain kinds of inventory reserves?

A. Not if the reserves are created to really measure the decline in the market value of the inventory.

Arbitrary reserves, no, but reserves that are designed with some sophistication to accomplish the ends of lower of cost or market are completely acceptable.

Q. What kind of arbitrary reserves are not acceptable under generally accepted accounting principles?

A. Reserves which were whimsically designed to achieve a profit manipulation or something of that kind which were not geared to appraisal of the conditions that made the reserve appropriate.

Q. Would you characterize the reserve for excess inventory utilized by Thor as an arbitrary reserve or one permissible under generally accepted accounting [301] principles?

A. Not at all arbitrary and completely permissible.

Q. From the point of view of substance, is there any difference in accounting theory between establishing a reserve for excess inventory on the one hand or alternately simply writing off the excess inventory without reserving for it?

A. From an accounting point of view and a financial reporting point of view, no difference.

Q. Do generally accepted accounting principles and terminology recognize a distinction between a change in accounting principles on the one hand and a change in accounting procedure on the other?

A. Yes.

Q. Generally stated, what is the difference between the two?

A. A change in the accounting principles would create an inconsistency in financial statement preparation, so that the results determined in one year would not be consistent or comparable with results in a preceding year.

So that the auditor would have to draw attention to that fact and state in his opinion that there has been an inconsistency and

the effect of it, [302] if material, would be disclosed in the financial statements. Whereas, a change in accounting procedure would merely be applying the same principles as have been applied before, but the procedures in arriving at the principles may have varied from the accounting standpoint and also from the auditing standpoint.

Q. Would you characterize a change from the cash receipts and the disbursements basis to an accrual basis as a change in principle or a change in procedure?

A. That would be quite a significant change in principle if one assumes that the cash basis of accounting had validity in the first place.

Q. How about in the case of accounting for long-term contracts, a change from the percentage of completion basis to the completed contract basis of accounting?

A. That would usually be regarded as a change in accounting principle. There is quite a different approach in how income is being determined.

Q. How would you characterize a change from LIFO to FIFO inventory valuation or vice versa? Is that a change in principle or a change in procedure?

A. That would be a change in principle.

Q. How about a change from accelerated [303] depreciation to straight line depreciation or vice versa? Is that a change in principle or a change in procedure?

A. That is a borderline situation, but it probably comes nearer to being a change in principle in arriving at your depreciation charge.

Q. How about a change in computing a bad debt reserve from an age of account basis to a percentage of sales basis?

A. That I think would be a procedural approach to arrive at a satisfactory or sufficient bad debt reserve.

Q. Would you call it a change in procedure rather than a change in principle?

A. Yes.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

A. I think that, too, would be a change in your procedure for calculating depreciation, not a change in principle.

Q. How about a change from computing inventory quantities by complete count to computing them on the basis of sampling techniques?

A. That certainly would be procedural and not [304] principle.

Q. How about a change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours?

A. That, too, I think, is clearly a change only in procedure.

Q. Have you an opinion, Mr. Halvorson, if you will assume for a moment that the only change—strike that—that the only basis used by Thor for computing credits to its reserve for excess inventory in 1963 was on the basis described in Paragraph 6 of the Stipulation—Paragraph 6 of the Stipulation describes the basis or a basis used for computing credits for the reserve to excess in the years prior to 1964—

A. Yes. My copy at the moment is so faint I am having difficulty identifying Paragraph 6, but—here is No. 5.

Q. Paragraph 6 deals with—I will let you read it, Mr. Halvorson. Here comes a more legible copy.

A. No, I read it, but I can't decipher it in this copy at the moment. Yes.

Q. Assume that that was the only basis on which Thor computed credits to its reserve for excess [305] inventory in 1963, and that Paragraph 9 and 10 of the Stipulation describe the manner in which Thor computed credits to its reserve for excess inventory at the end of 1964—that is the formula that we have been discussing—and the additional credit of $160,000 described in Paragraph 10 of the Stipulation, have you an opinion as to whether there was a change in accounting prin-

ciples or a change in accounting procedure by Thor in this respect?

A. I think it was purely a change in accounting procedure. The principle still was to arrive at a lower of cost or market valuation and the resort to a formula or the adoption of a formula, you can say, was a refinement, if you will, of a matter previously used. It was directed toward exactly the same principle of accounting, a procedural approach which was changed to arrive at this same end.

Q. Have you an opinion, Mr. Halvorson, as to whether Thor's write down of its inventory, as of December 31, 1964 to account for excess was in accordance with generally accepted accounting principles?

A. Yes, I do. I think it was.

Mr. Abrams: Your Honor, I have nothing further with respect to the inventory issue, but consistent with respect to the practice we followed [306] Friday, Mr. Berens will examine on the bad debt issue before cross examination.

The Court: Very well.

Direct Examination by Mr. Berens.

Q. Mr. Halvorson, I direct your attention to Petitioner's Exhibit 18 which I believe you have there, entitled Analysis of Bad Debt Reserve Requirement as of December 31, 1965, and ask you if you have reviewed that document?

A. I have.

Q. Could you describe generally, based on that document, what the Petitioner did in evaluating its bad debt reserve for that year?

A. Yes. Looking at the exhibit beginning with its inter-company accounts, the conclusion was that no reserve was required for collection of them.

Going down to the trade accounts with the customers, not the inter-company accounts, the conclusions differed somewhat, depending upon the nature or the condition of the accounts and

in some cases a 100 per cent reserve was provided against specific accounts and a reserve equal to either one or two per cent of the unpaid balance was applied to other accounts in arriving at the appropriate reserve, at [307] the end of 1965.

This was based on the age of the accounts. As I understand it, at most of the locations, accounts, current accounts were considered to be subject to a reserve of one per cent. Accounts somewhat older than that were subject to a reserve provision of two per cent, and in certain cases accounts which were 90 days or more past due, on which there appeared to be serious credit problems, were covered by a 100 per cent reserve on the basis of their age at that particular time.

Q. Do you consider a 100 per cent reserve for certain hard core accounts to be consistent with generally accepted accounting principles?

A. Yes, I do.

Q. Is this a fairly customary thing in your experience for companies to take this sort of reserve on specifically identified accounts?

A. Yes, it is.

Q. Do you have an opinion as to the validity of this system which takes into account past and current data as compared with a mechanical system wherein the actual experience of a particular taxpayer over six years is used as a basis of its bad debt reserve?

[308] A. Yes.

Q. Would you state that opinion?

A. I think typically the more current the information is upon which one predicates a bad debt reserve, the better the reserve will be, the more precise it will be, if you will; that a review of the accounts as they exist as of a given date offers a better basis for providing a reserve than would a statistical approach predicated on experience over a period of time.

Q. Assuming that the difference would be material, would you withhold an unqualified opinion if the mechanical approach, in your opinion, resulted in an inadequate reserve?

A. Yes, we would withhold an opinion if the reserve appeared to be inadequate without regard to how it was arrived at.

Mr. Berens: No further questions.

Mr. Sherman: I just have a couple of questions.

Cross Examination by Mr. Sherman.

Q. With respect to the excess inventory matter, if we assume that at the end of 1963 Thor's condition with respect to excess inventory also existed in [309] approximately the same, to approximately the same extent as it did at the end of 1964, would you, if you were the independent accounting firm for Thor, have also required, in order for an unqualified certification, would you have also required Thor to write down its inventory as of December 31, 1963?

Mr. Abrams: Your Honor, I object to the question on the ground it assumes facts that are not in evidence.

Mr. Sherman: I said if it be assumed, Your Honor. This is a hypothetical question.

Mr. Abrams: Proper hypothetical questions, Your Honor, are to be based on facts in evidence. I understand Mr. Sherman does not have the intention of putting on any evidence with which he could connect this question up.

Mr. Sherman: If the Court please, I believe the question, I believe the foundation does exist in the pleadings which Thor has filed and in the Stipulation to which it was a party. I regret that it is necessary now to take these pleadings apart and read them. I think counsel for the Petitioners is aware of what Thor's pleadings state.

Mr. Abrams: If Mr. Sherman states that the fact is of record, Your Honor, I will withdraw my [310] objection without making him go through all those papers at this time.

The Court: Very well, you may answer the question, Mr. Halvorson.

By the Witness:

A. Yes. Usually you would recognize in the accounts the effect of an inventory deterioration or a loss at the time it was first recognized, and if it could be demonstrated that the inventory at the end of 1963 had been stated in error, there might be a case for going back and reconstructing the 1963 financial statements to reflect at that time some of the deterioration.

It would be quite unusual in respect of inventories, however, to find that condition existing. Although, not knowing myself anything of the surrounding facts vis a vis '63 and '64 here, I can't give you an answer as to what we might have done at that particular time.

By Mr. Sherman:

Q. But going back now to the question that you were asked on direct examination with respect to whether you would qualify your statement if you were Thor's auditors in 1964 and this fact came to your attention, wouldn't you give the same answer with [311] respect to 1963 if the same question were asked, except that the year in question was 1963?

A. If we came to the 1964 inventory and had previously expressed an opinion on the 1963 inventory without qualification, I would have to assume that we had been satisfied, based upon the evidence in hand at the end of 1963, that that inventory had been stated at the lower cost or market at that time and, therefore, would not go back and change it or introduce a qualification retrospectively; but you must understand that the size of the 1964 provision was, let us say, large in relation to the year. It could be that there is in there some element of unrecognized past excess. I don't know.

Q. If you had been the auditors for Thor in 1964 and you were satisfied that the only procedure which had been previously used for writing down inventory had been the procedures adopted in Paragraph 6 of the Stipulation of Facts, the 10 per cent amortization of the parts and accessories for items no

longer currently produced, and that the procedures described in Paragraphs 9 and 10 of the Stipulation of Facts had first been adopted in 1964, would you provide any notation or other statement as part of the profit and loss statement to indicate such change?

[312] A. I don't believe I would. I would consider that in each case a diligent effort, if you will, and appropriate judgmental factors are being applied to arrive at a lower cost or market and that the fact that the procedure had not been the same in the two years would not require financial statement disclosures or mention in the auditor's reports.

Q. In other words, from the point of view, I take it, of generally accepted commercial accounting procedures, this would not be considered a change requiring any particular comment and/or notation with respect to the profit and loss statement?

A. In my opinion it would not require a comment either in the note to the statement or in the auditor's report on the statements.

Mr. Sherman: No further questions.

Redirect Examination by Mr. Abrams.

Q. Mr. Halvorson, in your opinion what is the best basis for determining the year in which a particular excess inventory actually became excess?

A. What is the best means of determining the year that it became excess?

Well, I don't know if there is a best year. You look at each year as it comes and consider the [313] record, if you will, as to what the past performance in respect of the item is and what the future performance may be, and try to arrive at a determination at the time, year by year. So—

Q. But if you determine that particular year that an item is at that time excess,—

A. Yes?

Q. —how do you determine when it actually became excess?

A. I think I would determine that the excess arose at the time it was first identified as such.

I still don't quite know how to answer your question. How do you determine the year in which it became excess?

I should imagine, as I say, you look at past performance and you estimate future performance, and once they get out of balance, experience shows you what you are going to use or what your judgment tells you what you are going to show in the future is the year in which the excess emerges.

Q. And in your view it becomes excess when it is first identified as being excess?

A. That is when you would first give accounting recognition to it, but you say when it becomes excess would be a factual thing, but the information to make [314] the determination might not be there, if you will.

Q. If in a particular year management determines that certain items appear to be excess—

A. Yes?

Q. But there are factors indicating that management should have made that determination earlier with respect to those items, what is the appropriate accounting treatment?

A. In the ordinary case I believe the excess would be given recognition at the time the determination was made, even though there may be indications that the condition may have been a creeping one or a latent one. Typically you do not go back and undo what has been done unless it is a very aggravated situation indeed.

Mr. Abrams: I have no further questions, Your Honor.

Mr. Sherman: No further questions.

The Court. Thank you, Mr. Halvorson.

(Witness excused.)

*   *   *

[315] Mr. Abrams: Petitioner would like to call as its next witness Mr. H. B. Burris.

HOWARD BARRY BURRIS, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir, and state your name and address for the record.

The Witness: Howard Barry Burris, B-u-r-r-i-s, 58 Far Brook Drive, Short Hills, New Jersey.

Direct Examination by Mr. Abrams.

Q. What is your profession, Mr. Burris?

A. I am a Certified Public Accountant.

Q. How long have you been in public accounting?

A. Since 1950.

Q. With what firm are you presently associated?

A. I am presently associated with S. D. Leidesdorf & Company as an audit partner.

Q. In which office of that firm do you work?

A. In the New York office.

Q. How long have you been with S. D. Leidesdorf & Company?

[316] A. I began with Leidesdorf in 1954 as staff auditor. I was a staff auditor from '54 through 1960, a manager with them to '65. In 1965 I left Leidesdorf to take a position in private industry, as a treasurer of a company, and returned in 1966 and I have been an audit partner with them since then.

Q. In which phases of public accounting have you principally been occupied since you joined Leidesdorf?

A. Almost exclusively as an audit partner dealing with commercial organizations, manufacturing companies and the like.

Q. On what committees of the American Institute of Certified Public Accountants have you served?

A. I am presently a member of the Committee on Auditing Procedure which is the senior technical committee on auditing authorized to issue pronouncements on auditing procedures for the profession.

Q. Would you state generally the considerations which apply in valuing assets for balance sheet purposes?

A. Assets generally would be valued for balance sheet purposes at cost reduced in those instances to net realizable value or fair value in those circumstances where warranted, generally at cost.

[317] Q. What goals do you seek to achieve in valuing assets for income statement purposes?

A. The purpose of valuing assets for income statements would be a proper matching of costs and revenues, to have the costs fall in the proper period, the valuations fall in the period that an expense should occur.

Q. How would you apply the principles you have just described to valuation of inventory?

A. For balance sheet purposes, inventory would be valued in accordance with generally accepted accounting principles at the lower of cost or market, so that at balance sheet date we would have a valuation at cost reduced to a net realizable value concept, which in turn would result in a proper matching of costs and revenues for income statement purposes.

Q. What is net realizable value?

A. Net realizable value is a criteria for determining market value. It has upper and lower limits.

Market value is defined as replacement costs which will not exceed net realizable value, that is, sales price less cost of completion and cost of disposal, the lower limits being the net realizable value reduced by a normal gross profit margin.

[318] Q. What treatments do generally accepted accounting principles require with respect to excess inventory?

A. Excess inventories should be reduced in value from cost to its net realizable value to arrive at the lower of cost or market concept.

Q. How would you define "excess inventory" from an accounting point of view?

A. Excess inventory would be that quantity of inventory in excess of normal business requirements that cannot be disposed of or probably may not be disposed of at its normal selling price.

Q. Do you have to wait until an item is actually scrapped before you write it down as excess?

A. Absolutely not. You should write down inventory at the time you recognize that it is excess or will not result in sales at normal prices.

Q. Is that an optional procedure or a mandatory one, writing down of excess?

A. That is a mandatory procedure which is required by the concept of lower of cost or market.

Q. If you were the auditor of a manufacturing company which refused to write down its inventory for excess, what action would you take?

A. We would refuse to issue an unqualified [319] opinion, we would issue a qualified opinion. If the amount involved were material and we were able to determine the amount, we would probably issue an adverse opinion.

Q. In the case of a company that accounts for its inventory on the lower of cost or market, is there any substantive difference between a write down to market and a write down of obsolete items?

A. Would you repeat the question?

Mr. Abrams: Would you read it back please?

(Whereupon the record was read.)

By the Witness:

A. No, there is no substantive difference at all. The obsolete item write down would be in line with the concept of writing down to market.

By Mr. Abrams:

Q. Is there any substantive difference between a write down for excess and a write down for obsolete?

A. No, the principle is the same.

Q. Do generally accepted accounting principles permit the write down of excess inventory through the use of a formula based on prior usage?

A. Absolutely. A formula method of write down, that procedure would be consistent with generally accepted accounting principles.

[320] Q. And is it permissible to use prior usage as the basis for the formula?

A. Yes, the prior usage generally would be a very good barometer and indicator of future requirements. A formula based on prior usage is a very common way of writing down obsolete and excess inventories.

Q. Under what circumstances do generally accepted accounting principles permit the usage of a formula as a means of computing a write down for excess?

A. Generally, where the specific identification on an item by item basis would be impracticable or cumbersome, such as an inventory with a great number of units where a large quantity of inventory, relatively homogeneous in type, would lend itself to a formula basis.

Q. In the course of your auditing experience, have you observed and approved the use of formulas based on prior usage as a means of writing down for excess inventory?

A. Many times.

Q. Prior to your testimony this morning, Mr. Burris, have you had an opportunity to observe the Statutory Notice of Deficiency that was issued to [321] the taxpayer?

A. Yes, I did.

Q. Did you also observe the petition that Thor filed in this cause?

A. Yes.

Q. And the Answer of the Respondent to that petition?

A. Yes.

Q. Have you also reviewed the Stipulation of Facts?

A. Yes.

Q. Have you had an opportunity to examine Exhibits 13 through 19—pardon me, 13 through 20, and 22 through 27?

A. Yes, I did.

Q. On the basis of your review of those materials and your general experience, have you an opinion as to whether it was appropriate in accordance with generally accepted accounting principles for Thor to write down its excess inventory in 1964?

A. On the basis of reviewing the procedure used at December 31, 1964 and the subsequent events as shown by the exhibits, it is my opinion that it was mandatory for them to write down that inventory, the excess quantities, to be in accordance with generally [322] accepted accounting principles.

Q. If you had been Thor's auditor at the end of 1964 and Thor had refused to write down its inventory to reflect excess, what action would you have taken?

A. We would have refused to issue an unqualified opinion. Our opinion would have been qualified or we might have disclaimed an opinion on those statements.

Q. Now, Mr. Burris, directing your attention to the Stipulation of Facts, and in particular Page 5, Paragraph 8(b), which describes the number of inventory items, the different types that Thor had at the end of 1964. On the basis of that portion of the Stipulation, have you an opinion as to whether generally accepted accounting principles permitted Thor to use a formula as a means of writing down its excess inventory?

A. Yes, that inventory consisted of 44,000 separate items, and it is my opinion that 44,000 items would make the use of a formula method almost obligatory. It would not be practicable to value that inventory for lower of cost or market on an item by item basis.

Q. Now, Mr. Burris, directing your attention [323] to Page 6 of the Stipulation of Facts, and in particular Paragraph

9(c), which describes the formula which Thor used at the end of 1964. Have you an opinion as to whether that formula appears to be theoretically consistent with generally accepted accounting principles?

A. Yes, the use of a formula in this case or in any case is a procedural matter. The generally accepted accounting principle is the lower of cost or market. The procedure used with respect to this formula is a reasonable formula, and its application would be consistent with the lower of cost or market concept, which is a generally accepted accounting principle.

Q. Would it be consistent with generally accepted accounting principle, or was it, to use a formula which gave no value to inventory items in excess of two years' anticipated usage?

A. Yes.

Q. Have you in the course of your experience observed and approved formulas used by other companies which gave no value to inventory items in excess of two years' anticipated usage?

A. Yes.

Mr. Sherman: Object to it. It is [324] irrelevant.

Mr. Abrams: Your Honor, I think the extent to which this witness has observed similar formulas goes to the weight of his opinion—observed and approved them as being in accordance with generally accepted accounting principles goes to support his testimony as to the propriety of this particular formula used in this case.

The Court: I will overrule the objection. I think it is relevant to establish the weight of his testimony as an expert.

Mr. Abrams: Would you read the question back please?

(Whereupon the record was read.)

By the Witness:

A. Yes. The determination that there is no value to inventory in excess of a given period of time will vary. I have seen formulas where no value is given to inventory in excess of one

year. Past usage and historical needs plus the gross profit rate and many relevant circumstances will determine at what point no value is given, but certainly no value being given to two years is not inconsistent with generally accepted accounting principles and is a reasonable basis.

[325] By Mr. Abrams:

Q. Have you approved formulas used by clients of yours that gave no value of inventory in excess of one year anticipated usage?

A. Yes.

Q. Now, Mr. Burris, would you direct your attention, please, to Petitioner's Exhibit 19, which is captioned "Summary of Tests of Reserve for Excess Inventory by Arthur Andersen & Company."

In considering that exhibit, Mr. Burris, assume that Thor used the same formula which is described in Paragraph 9(c) of the Stipulation for valuing its excess inventory during each of the years from 1964 through 1971. On the basis of that assumption and your review of Petitioner's Exhibit 19, have you an opinion as to the reasonableness of the amount of the credit to Thor's reserve for excess inventory at the end of 1964?

A. Yes. On the basis of the Arthur Andersen exhibit, which was performed in 1970, it is my opinion that the reserve used at the end of '64 was a reasonable reserve, possibly resulting in a reserve less than required—can I go on into one of the next exhibits?

Q. Certainly.

A. Because Exhibit 19 indicates that the reserve [326] at 1970 was understated by approximately 17 per cent. This would be consistent with the decreasing sales trend indicated on Exhibit 20. The inadequate reserve, the understatement by $36,000 is consistent with the decreasing sales trend, and since the formula was based on past usage in 1964, it would indicate that there was probably some understatement in that reserve at the end of '64 which followed its way through to 1970.

Q. Would you explain why the declining sales trend leads you to that conclusion?

A. Because a usage formula is based on the preceding year's usage. In a period of decreasing volume, the actual usage incurred in the subsequent year will be less than the estimate which is based on the preceding year's higher volume.

Q. Now, Mr. Burris, will you direct your attention, please, to Petitioner's Exhibit 22, which is captioned "Reserve For Excess and Obsolete Inventory."

On the basis of your review of that exhibit, have you come to any conclusion as to the reasonableness of Thor's reserve for excess inventory and the credit thereto in 1964?

A. Yes. On the basis of 1965 through 1971 [327] dispositions and additional provisions, it is my opinion that the reserve at the end of 1964 was a reasonable reserve because of the need for additional provisions in each of the subsequent years, coupled with the fact that the dispositions in those subsequent years, although less than the provisions to the reserve in total through 1964, there were several factors entering into that lag.

Number one, the fact that there probably was dispositions that were unrecognized. In any manufacturing operation, you are going to dispose of obsolete inventory, excess quantities, throw away stuff which is not recorded. You only record that which you see, not which gets wasted. Coupled with the fact that I would assume that at the end of any given point in time there will still be inventory on hand that will be thrown away at a later period, all of these causing the dispositions to be less than the provisions, but the dispositions in relation to the provisions in each of those years indicate that the reserve established at the end of '64 was a reasonable reserve.

Q. Now, Mr. Burris, would you direct your attention to Petitioner's Exhibit 17, which is captioned "Analysis of Depositions at Aurora and Los Angeles."

[328] Assuming, Mr. Burris, that the dispositions shown on Petitioner's Exhibit 17 relate entirely to excess items, have you an opinion on the basis of this exhibit as to the reasonableness of the credit to Thor's reserve for excess inventory at the end of 1964?

A. Yes. The total inventory reserve at the end of '64 was $1,079,000, of which 846,000 was attributable to Los Angeles, Aurora and branches.

Now, I understand that through 1971, $657,000 was the amount of dispositions at Los Angeles and Aurora, which is 78 per cent of the total related reserve of 846 on those items.

That would indicate to me, based on the fact that 78 per cent was disposed of, the items that I mentioned before, that a certain portion of dispositions of inventory is usually not recorded, and assuming that a portion of that inventory reserve in '64 may even still rest in certain plants, it would appear to me that the '64 reserve of 1,079,000 is reasonable based on a 78 per cent disposition factor.

Q. Mr. Burris, I am directing your attention particularly to the fact that the 846 item referred to in the second line of the summary relates to Los Angeles, Aurora and branches, and that the [329] disposition of 657,000 in the third line relates only to Los Angeles and Aurora. What relationship does that have on the opinion that you just expressed?

A. It means that the 78 per cent would be a higher number, I can't evaluate how much higher without knowing how much of that inventory rested at branches, but knowing it would be greater than 78 per cent, it would re-enforce my opinion that the dispositions throughout the '64 through '71 with respect to the items in inventory in '64 was reasonable.

Q. And that the amount established at the end of '64 was also a reasonable amount?

A. Was a reasonable reserve.

Q. Now, Mr. Burris, would you direct your attention, please, to Paragraph 10 of the Stipulation of Facts, beginning at the bottom of Page 6 and continuing to the top of Page 7.

Now, this refers to the credit to the reserve for excess inventory which was based on estimates other than the formula described in Paragraph 9 of the Stipulation of Facts.

Would you also direct your attention to Petitioner's Exhibit 13, which tabulates the amounts of the credit to the reserve based on this additional [330] estimate.

Have you an opinion as to whether this additional write down of $160,000 computed not on the basis of the formula, but on another basis, was in accordance with the generally accepted accounting principles, even though Thor used a formula for the bulk of its inventory write down for excess?

A. Yes, the formula was a procedure used to arrive at a lower of cost or market concept. Based on Paragraph 10, the past usage records was inadequate and therefore this formula would not be appropriate.

The procedure used on this reserve would not in any way violate the concept of generally accepted accounting principles, it being a procedure, and it is a reasonable procedure in given circumstances. There is nothing wrong with using both a formula and a specific identification type of items at the same time.

Q. Under generally accepted accounting principles and terminology, is it appropriate to characterize Thor's manner of its accounting for inventory at the end of 1964 as lower of cost or market?

A. Yes.

Q. Do generally accepted accounting principles prohibit the use of certain types of inventory [331] reserves?

A. Not if they are inventory valuation reserves to arrive at a lower of cost or market concept, no.

Q. What kind of inventory reserves are prohibited by generally accepted accounting principles?

A. General contingency reserves, reserves unrelated to the facts and circumstances at a given point in time. A valuation reserve, such as we are discussing here, would not be prohibited by generally accepted accounting principles.

Q. By that, you mean the reserve that Thor used?

A. That is correct.

Q. Is there any substantive difference from the point of view of generally accepted accounting principles between establishing a reserve for excess inventory or merely writing that excess inventory off the books without the use of a reserve?

A. None at all for accounting purposes. As a matter of fact, when a formula method is used, it would probably be more appropriate to use a reserve as opposed to a specific write off because of the inability to identify an item by item basis.

Q. Do generally accepted accounting principles and terminology recognize a distinction between a change in accounting principles on the one hand and a [332] change in procedure?

A. A change in principle from an auditor's point of view would result in a statement that the company has changed from one generally accepted accounting principle to another.

A change in procedure would not necessarily warrant any comment at all.

Q. Would you describe the change from the cash receipts and disbursements basis to the accrual basis as a change in principle or a change in procedure?

A. That would be a change in principle from an unaccepted accounting principle to a generally accepted accounting principle.

Q. How about in the case of accounting for long-term contracts, a change from the percentage of completion basis to the completed contract basis of accounting?

A. That would also be a change in accounting principle.

Q. Would you describe as a change in principle or a change in procedure a change from LIFO to FIFO inventory evaluation or vice versa?

A. That would be a change in accounting principle.

Q. How about a change from accelerated [333] depreciation to straight line depreciation or vice versa?

A. That would be a change in accounting principle.

Q. How about a change in computing a bad debt reserve from an age of account basis to a percentage of sales basis?

A. That would be a procedural change.

Q. How about a change from computing depreciation on the basis of lives of individual items to computing it on the basis of lives of groups of items?

A. That would also be a procedural change.

Q. How about a change from computing inventory quantities by complete count to computing them on the basis of sampling techniques?

A. That would strictly be a procedural change.

Q. How about a change from allocating overhead on the basis of labor dollars to allocating it on the basis of machine hours?

A. Also a change in procedure, not a change in principle.

Q. Now, Mr. Burris, I direct your attention, please, to Paragraph 6 of the Stipulation of Facts.

Assuming that at the end of 1966—1963 the only computation of excess inventory by Thor was done [334] in the manner described in Paragraph 6(a) of the Stipulation of Facts, and assume further that in 1964 Thor computed credits to its reserve for excess inventory in the manner described in Paragraphs 9 and 10 of the Stipulation of Facts, that is, by means of the formula and the special credit of $160,000 that we have described. In your opinion, does that represent or would that represent a change in accounting principle or a change in accounting procedure?

A. That would represent a change in procedure, not in principle. The accounting principle would be to value inventory at the lower of cost or market. The change to a formula method is a procedural change, not a change of principle.

Q. Now, assuming, Mr. Burris, that the management of a company concludes in a particular year that it has excess inventory, and assume that some of those items might actually have become excess in a prior year but had not been recognized as

such by management. What is the appropriate accounting treatment, in your opinion, in the year in which management concludes or determines that there is excess?

A. At the time that management determines there is excess inventory, that excess inventory should be recognized by a write down in inventory at that time.

[335] Q. On the basis of your review of the documents which you have referred to earlier in your testimony and your general experience, have you an opinion as to whether Thor's write down of its excess inventory as of December 31, 1964 was in accordance with generally accepted accounting principles?

A. Yes, it is my opinion that that write down was in accordance with generally accepted accounting principles.

Mr. Abrams: Your Honor, I have no further questions of this witness with respect to the inventory issue, but Mr. Berens does wish to examine him with respect to the bad debt issue.

The Court: Very well.

Direct Examination by Mr. Berens.

Q. Mr. Burris, I refer you to Petitioner's Exhibit No. 18, entitled "Analysis of Bad Debt Reserve Requirement as of December 31, 1965," and ask if you are familiar with that document.

A. Yes.

Q. Would you describe, based on what is contained in that document, your understanding of what the Petitioner did in evaluating its bad debt reserve that year?

[336] A. The Petitioner analyzed its accounts receivable by type and age of accounts, such as inter-company accounts, wherein no reserve was provided, and then other accounts. A reserve was provided based on a specific identification of certain accounts termed "hard core" of 100 per cent and reserves varying between 1 and 2 per cent was provided on the balance of the accounts based on an aging of those accounts receivable at December 31.

Q. On the [face] of it, does the method used by the Petitioner seem to be consistent with generally accepted accounting principles?

A. Yes, it is a very common method.

Q. Again, does it seem to be on the face of it a realistic practice, procedure?

A. Yes, the procedure of identifying specific accounts and then using a percentage based on an aging is a very common method of applying a reserve.

Q. If that method actually used by the Petitioner compared with a six-year moving average of its actual experience in its bad debt charge offs, do you have an opinion as to which method would be more likely to give a fair and more accurate result?

A. Well, it is my opinion that the more current information would recognize more current happenings. [337] The five or six year moving average would disclose what has happened historically, but would not be a complete barometer of the condition of the accounts at a given point in time.

At December 31, 1965 I would much prefer to see an aging of the accounts at that time rather than the historical write off experience.

Q. If conditions have changed over the six year period, is it possible that the mechanical averaging formula could yield an inaccurate result that might require a qualified opinion if it were material?

A. Yes, especially if the condition changed in the last year because of the weighting of the earlier years would have greater weight the later the conditions changed.

Q. Does a reserve of 100 per cent of certain specifically identified hard core accounts present any difficulties to you in evaluating the procedure used by a client?

A. No, not if the accounts are recognized as being remote of collection or no chance of collection at all. It merely indicates a valuation of no possibility of collection.

Q. Could a substantial increase in the so-called hard core accounts be a sort of change of events that [338] would make an averaging method over six years inaccurate?

A. Yes.

Mr. Berens: No further questions.

Mr. Sherman: I have no questions, Your Honor.

The Court: Thank you. You are excused, Mr. Burris.

* * *

[340] Mr. Berens: Mr. Weston, would you take the stand, please?

(The witness was duly sworn.)

FRANK T. WESTON, was called as a witness on behalf of the Petitioner, and, having been first duly sworn, testified as follows:

The Clerk: Be seated, please, sir. State your name and address for the record.

The Witness: My name is Frank T. Weston, W-e-s-t-o-n, 19 Timberline Road, Hohokus, New Jersey.

Direct Examination by Mr. Berens.

Q. Would you state your profession, Mr. Weston?

A. Yes, I am a Certified Public Accountant, a member of the public accounting firm of Arthur Young & Company.

Q. How long have you been a Certified Public Accountant?

A. I received [my] CPA certificate in the State of New York in 1939, and I have been with Arthur Young & Company continuously since 1937.

Q. Would you outline generally your career with [341] Arthur Young & Company?

A. I started on the audit staff in the New York office of Arthur Young & Company, and progressed up through the ranks becoming a manager in due course.

I was transferred to Boston in 1947 as Manager in charge of our Boston office. I was admitted as a partner to the firm in 1950, and returned to Boston—returned from Boston to New York in 1954. At that time I entered the home office of Arthur Young & Company, and was in charge of the SEC and Research Department.

I subsequently became Assistant National Director of Accounting and Auditing Standards, and in 1963 became the National Director for the Accounting and Auditing Standards.

I now hold the post of Chairman of our firm's Committee on Accounting and Auditing Standards.

Q. When you referred to the—being the National Director of Accounting and Auditing Standards, you mean of Arthur Young & Company.

A. Yes.

Q. When you were engaged in audit work, did this experience include that of manufacturing companies generally?

A. Yes. My audit experience covered various [342] types of industries, including manufacturing companies.

Q. Would you describe your role as National Director of Accounting and Auditing Standards and as Chairman of the Committee on Accounting and Auditing Standards in terms of your work in the firm?

A. Our firm has a home office organization consisting of probably 20 to 30 partners who are involved in setting policies, disseminating policies, passing on major accounting and auditing problems, preparing manuals and handbooks of instructional nature for our various offices and staffs around the country and around the world, and generally responsible for the determination of firmwide policy involved in representing the firm in matters where that is appropriate.

Q. Approximately how many professional accountants are partners or Managers or employees of Arthur Young & Company?

A. Well, this October 1st we will have approximately 400 general partners, and our total personnel will probably be in the neighborhood of 4,000 in this country.

Q. Would you outline your membership of various committees of the American Institute of Certified Public Accountants?

[343] A. I have been active in various professional organizations, both in the Massachusetts C. P. A. Society and in the New York Society. However, most of my effort has been involved in the National Society, the American Institute of Certified Public Accountants.

I have been a member, and for some years Chairman, of the Committee on Relations with the Securities and Exchange Commission and the stock exchanges, and I have recently completed a seven-year term on the Accounting Principles Board running from October, 1964 until December 31, 1971.

I am presently a member of a study group of the National Organization charged with establishing the objectives of financial accounting, a nine-man study group.

Q. Would you describe the function of this study group in a little more detail?

A. Well, as you know, there has been some discussion or some criticism of accounting in recent years primarily leveled at the charge that accounting is not responsive to the needs of users of financial statements; that our present accounting conventions are not responsive to economic reality; that balance sheets don't really show the net resources of companies, criticisms along those lines.

[344] In addition, there are some contrary criticisms that accounting does not show the cash flow activities of corporations or the liquidity of corporations which became rather important in recent years when liquidity became a problem.

So our charge basically is to review the present systems and conventions and principles of accounting, and to try to define objectives which will make accounting more useful in the future to users of statements.

Q. Would you state in general terms, Mr. Weston, the purposes of inventory accounting with respect to balance sheet presentation?

A. Well, the general objective of inventory accounting as is the case with most assets, is to establish amounts to be carried forward in a balance sheet which will enable the corporation to report its financial position at a year end, and the results of its operations for usually a 12-month period ended that date.

The accounting objectives are to take, if you will, the activities of a corporation over its entire life, which may run, as we know, in perpetuity, and to break that down into annual segments in such a way that management and investors and creditors and [345] governmental agencies will have some measure of the activities of that corporation in its economic efforts.

Therefore, we have developed conventions in accounting whereby assets are carried forward from one period to the next; that is, from the period in which they are acquired to some future period in which they will be used or generate revenue for the corporation.

So then we establish valuation or costing techniques which result in carrying inventories and other items in the balance sheet at amounts which purport to reflect the utility of those items.

In the case of inventories, we have rather precise and detailed rules which say that the inventories shall be carried at their cost as long as that cost does not exceed their utility. In terms of utility, in our professional literature, that word is translated to mean net realizable value which, in turn, means the amount to be realized on sale less costs of disposition.

So we have established in the inventory area a conservative lower of cost or market approach so that the inventory values presumably show the reader the amount which will, in fact, be realized based upon best information available when those [346] financial statements are prepared.

The contra to that, to come back to your question as to the income statement, is that having measured the proper amount to be carried forward in the balance sheet for an inventory item, we then have, in fact, computed the proper amount to be charged to the interim periods between balance sheets, since the utility test, or the fair value, or the realization test at each balance sheet must then automatically charge or credit to the income statement between balance sheets the appropriate amount so that each period then bears its proper share of costs of the activities of the company, and the reflection of value changes on inventories at least on the downward side.

That is basically a conservative approach to inventory valuation which is reflected in the accounting conventions.

* * *

Q. You spoke, Mr. Weston, of valuing inventory basically at cost unless its net realizable value is lower, at which time it has to be adjusted downward [347] accordingly.

Could you give me some examples of situations where it is necessary to reduce inventory to a lower net realizable figure?

A. Well, the circumstances requiring a reduction to net realizable value are, of course, quite different and depend on the circumstances of the industry involved. Certainly a question of obsolete inventory would raise questions as to the necessity for a write down to market. If new models are coming in and the company has a supply of parts or models or equipment or trucks or airplanes, any inventory item basically whose utility is indicated to be decreased because it has been superseded in the marketplace by a more efficient, a more productive item, certainly that requires an inventory adjustment.

Other similar reasons for adjustments would be damage to goods on shelves, handling, damage of that sort.

A decline in market entirely apart from the obsolescence factor, that is, a general downturn in prices particularly involving raw materials or products made from raw materials where a basic raw material price declines considerably. And then we also have a situation where for one reason or another, a company [348] may have more quantities of an inventory on hand than it can reasonably expect to sell, and that under the conservative approach of net realizable evaluation which guides inventory accounting it would also require an adjustment of inventory.

Q. Could, in the last category that you mentioned of excess inventory, could you give some illustrations where an excess inventory situation is created?

A. Well, we have some examples in recent years in the small airplane industry where the demands are moving from the propeller-driven planes to jet aircraft. This would be in the executive area. And also in certain cases in the commercial area where planes which have been produced for a market have suddenly become unsaleable because the market has changed and has accepted a more advanced technological product.

Other cases involve generally product model lines of business, lines of product, particularly with companies who have warranty or continuing service requirements where again a change in consumer tastes or competitive disadvantage has caused a corporation's product to become, in effect, not saleable at the basis at which it is carried.

[349] Q. Does this type of situation occur commonly where a company has a substantial service—after market service business?

A. Yes. This is an area which is often troublesome because of the commitments of such companies to service the product, and obviously the—their service reputation has a great deal to do with the ability to sell such items.

So most corporations in that type of business do carry a fairly good inventory in terms of quantities and diversified parts for most of their models, and they have a problem of carrying those inventories that come before them as the years go by.

Q. If such a situation exists for the inventory, that it is excess, whether it is spare service parts or otherwise, do generally accepted accounting principles require that this inventory be written down to net realizable value?

A. Yes. I would say there is no doubt that the fair value, the net realizable value test, and the utility test, which are all wrapped up into our cost or market whichever is lower theory, would require that excess inventories be reduced in carrying value under those circumstances.

Q. Are there any exceptions under generally [350] accepted accounting principles to this proposition you just stated?

A. No. There would be no exceptions in the general area that you stipulate. The only conceivable exception might be someone who had a price protected contract; that is, where there is a service contract with a stated price. Those are quite rare, and there it would be clear that the net realizable value would be as stated in the service contract.

Q. If your firm were auditing a client who had, in fact, excess inventory but was disinclined to write it down to net realizable value, what would you do?

A. Well, we would try very hard, of course, to convince the client that a write down, a reevaluation of the inventory in the balance sheet was essential, and failing in that, we would be inclined to say—in fact, we would say that we would not be in a position to give that client a clean opinion or an unqualified opinion; that is, we would take exception to carrying the inventory without some downward revaluation.

Q. Is it essential that the item be scrapped in order to write it down as excess to net realizable value?

[351] A. No. The physical scrapping of inventory is not an integral part of the valuation process. It may still be on hand and often is carried on hand.

Q. In the event that ending inventory were overstated because of the existence of excess quantities that were not valued downward to net realizable value, what would the effect of this be on the income for the current year and on the income for future periods?

Mr. Sherman: I will object to the question unless clarification is made as to what is meant here by "income." Income in the financial statement—

Mr. Berens: Yes. Income as reported income for generally accepted financial statements.

Mr. Sherman: No objection.

The Court: Very well.

By the Witness:

A. A determination that at December 31 of a given year an inventory contains excess inventory which was, as you stipulate, not reduced to its net realizable value, would result, in fact, in an overstatement of income for that year.

As to future years, presumably the inventory, if it were sold or scrapped at a price less than its carrying value, that loss would appear in some future [352] period's income statement, and under generally accepted accounting principles, that result would be improper; that is, the charge, the revaluation of the inventory, the write down to net realizable value, should be made in the year during which the nature or the excess was determined or existed.

By Mr. Berens:

Q. Could your—would you agree that your last statement could be paraphrased that the failure to write inventory down to net realizable value is to anticipate income between years?

A. Well, I am not sure I used the word "anticipate." I would say that it results in an improper shifting of the income between years. It should be—the charges should be made in the first year rather than in some subsequent year.

Q. From the viewpoint of generally accepted accounting principles, if a company is on the lower of cost or market inventory valuation, and it has excess inventory which is written down, is there any difference in theory justifying that write down between it being written down as an adjustment to market or being written down as a special type of obsolescence recognition?

A. No. From the point of view of generally [353] accepted accounting principles, the purpose, of course, is to carry the

inventory at the lower of cost or market, or the lower of cost or net realizable value, and the various elements or reasons which might cause a company to make such an adjustment are not differentiated from an accounting sense.

In other words, the nature of the item, the nature of—the reason why the adjustment is made, does not affect the necessity for the write down or its treatment in the account.

Q. In your experience, are there circumstances where the use of a formula can properly be used for evaluating excess inventory, and by "formula," I mean one based on usage or expected usage?

A. Yes. It is not uncommon in situations involving complex activity, or a great number of inventory items, to resort to a use of a formula as a convenient way of determining an amount of an overall adjustment to reflect net realizable value.

Q. And if this formula under the facts and circumstances is reasonable, it is in accord—is it in accord with generally accepted accounting principles?

A. Well, the results obtained by use of the formula, which is the write down to market, is what [354] generally accepted accounting principles require.

The formula is an appropriate method of arriving at that answer.

Q. And in your experience, is the use of such formulas for this purpose commonplace, or unusual?

A. I would say in the case of corporations with significantly large inventories, particularly service parts and parts involved in guarantees and warrantys, that it is not uncommon to use such an approach in determining net realizable value.

Q. Mr. Weston, have you—have you had an opportunity to read the statutory notice of deficiency in this case?

A. Yes.

Q. And the Petition filed by the taxpayer in this case?

A. Yes.

Q. And the Answer by the Government?

A. Yes.

Q. And the Stipulation of Facts—

A. Yes.

Q. —between the parties? And certain exhibits, particularly Exhibit Nos. 13 to 17, 19 and 20, and 22 through 27?

A. Yes.

[355] Q. Based on your review of these items, in your opinion was Thor obligated to write down any excess inventory it might have had in 1964?

A. Assuming that the determination of the excess quantities followed the stated formula, it would be my opinion that a write down to net realizable value was required under generally accepted accounting principles in 1964.

Q. And if you had been Thor's auditor at that time, and based on the premise you just stated, and Thor had refused to write down its inventory as indicated, would you have been able to give an unqualified opinion as to its financial statement?

A. No. In my opinion, our firm would not have given an unqualified opinion had such an adjustment not been made.

Q. I refer you to Paragraph—Paragraph 8 of the Stipulation, and particularly 8(b) referring to the number of parts in Thor's inventory at the end of 1964.

Based on that, I ask you whether it was appropriate or necessary for Thor to use a formula such as it did to value its excess inventory?

A. I would say, based on an inventory of that size, that is, with over 40,000 individual items, [356] that the use of some type of formula would be almost essential, and the purpose, of course, would be to save time, but still get some sort of a reasonable and practical answer under the circumstances.

This occurs quite often in accounting, where we have to balance the cost of doing a very detailed determination of some audit step; for example, looking at vouchers or checking inventories, or items of that nature, involving thousands of items. The cost to do a 100 per cent job in any of those areas is

prohibitive. So we do have some general ground rules, standards, whereby reasonable approaches to handling significant items, where the quantities involved are large, and they would be here, where techniques have been involved which are perfectly proper and acceptable.

Q. Did the particular formula used by Thor appear, in your opinion, to fall within these parameters you have just outlined?

A. Yes. Based on the material that I have reviewed, it seems to me that was a reasonable approach to this situation.

Q. And does your conclusion in that respect appertain also to the fact that it is basically estimated on future use by past years' actual use?

[357] A. Well, this is a difficult question in establishing a reserve of this sort. As in many areas of accounting, we are attempting to estimate future activities, future developments, and as in other areas, we find the various bits of evidence. Certainly, one of the most important bits of evidence in this area would be the actual sales for the current year. Add to that knowledge of management as to estimated changes in sales in the forthcoming periods, knowledge of industry, statistics of general economic conditions. There are a number of things which enter into such a determination, but certainly the usage or sales for the last year would be a good starting point.

Q. I refer you to Paragraph—I refer you to Paragraph 10 of the Stipulation and Exhibit—and Exhibit 13, which together outline the additional provision made by Thor in 1964 for excess inventory in the amount of roughly $160,000 which was supplementary to the formula approach, and ask you whether, in your opinion, a formula approach can be combined with a specifically additional charge such as this was?

A. As I understand the so-called "special reserve" to which you refer, this covered items or [358] areas of the inventory in which sufficient data was not available to follow the formula approach, and as I understand it, management undertook to make estimates of the amount of excess inventory based on their experience and understanding.

This is certainly a reasonable—a reasonable approach to a problem of this sort where data is not available. There would, of course, be a problem for the auditor in satisfying himself as to the basis on which management makes such a determination, and that would be a separate problem for the auditor.

However, there is no basic reason why a subjective evaluation of obsolescence of that sort made in good faith and based on whatever records are available should be considered to be in conflict in a realistic sense with the use of a formula with respect to the balance of the excess inventory.

Q. I refer you to exhibits previously mentioned, and in particular Exhibit No. 20—20 is the number I am trying to find—and ask you whether this—this material contained in that document leads you to any opinion regarding the validity of the provision made by Thor in 1964.

A. Well, it is difficult to express an opinion as to the adequacy of a reserve, based on a series of [359] income statements as appear on Exhibit 20.

However, as I understand the technique of the company, it did perform a formula computation at the end of every year, based on the same formula used in 1964. I do observe that net sales of this company decreased almost without exception every year which appears on Exhibit 20, and under those conditions, based on a formula which is based on current usage, I would expect that the reserve might well be less than would have been determined based on complete hindsight.

This is borne out in general by the figures at the bottom of Exhibit 20 indicating that the reserve increased in the years '65 and '67 significantly, and fluctuated in other years.

Q. Do I understand you correctly to indicate that the—so far as you can form a conclusion, the indication was that the '64 reserve may have been too little for excess inventory?

A. Well, my conclusion would be based on the decline in sales and the adjustment of the reserve; that it certainly was not overstated, and I would be inclined to, therefore, conclude that it might have been understated.

Q. All right. I refer you to Petitioner's [360] Exhibit No. 17, entitled "Analysis of Dispositions," and ask you if you are familiar with that.

A. Yes.

Q. Would you state any conclusions that you derived from this particular document?

A. As I understand Exhibit 17, this is an analysis of the dispositions by scrapping of individual items which were carried in the 1964 inventory and identified in the general nature of excess inventory.

The schedule then purports to show the dispositions of those items down through 1971, at Aurora and Los Angeles.

It then compares the total reserve at December 31, '64, in the amounts attributable to Los Angeles, Aurora, and some branches. It then shows the dispositions at Los Angeles and Aurora.

I understand there are some 20-odd branches involved, and the exhibit does not disclose the amount of the reserve attributable to the branches. However, it does indicate that dispositions to date have accounted for nearly 78 per cent of the related reserve provisions for Los Angeles, Aurora, and the branches, which would tend to imply or infer that the—if the branches had been included in the [361] disposition figures, the reserve requirements would have been higher than the 78 per cent shown.

So my conclusions, based on this analysis through '71, would be that the figure is—the figure in the reserve for Los Angeles and Aurora is within reasonable—a reasonable figure of—an appropriate figure, and that it may well be higher than the 78 per cent shown there.

In other words, the test basically of the workout of the inventory at '64 indicates that the reserve was within reasonable limits, based on these somewhat inconclusive data in terms of the branches.

Q. In your opinion, Mr. Weston, did Thor evaluate its inventory at the end of 1964 on the method known as the lower of cost or market?

A. Yes. Based on the information I have reviewed, I would say that the techniques involved were in accordance with the accounting approach for determining the lower of cost or market for this particular inventory.

Q. When you say "the accounting approach," you mean the approach that fulfills the requirements of generally accepted accounting principles?

A. Yes. Generally accepted accounting [362] principles, the lower of cost or market requirement.

Q. From an accounting viewpoint, was the fact that—or does the fact that Thor has charged these write downs to an inventory reserve account have any difference than if it had made direct write offs or write downs in the inventory for the excess inventory?

A. No. The use of a reserve valuation account, as in this case, is often done in order to avoid the detailed complications of attempting to trace each item as it moves during the year.

In fact, with a complex operation involving a number of locations, it is almost always handled through an inventory valuation account rather than a direct write down. It is just easier to keep track of things by running it through a separate inventory valuation account in terms of the balance sheets and income statements.

However, there is no substantive difference in the end result or the purpose of the accounting.

Q. On the basis of your review of the facts in evidence, is it—do you have an opinion whether Thor's write down of its inventories for excess as of December 31, 1964, was in accordance with generally accepted accounting principles?

A. In order to have an opinion as to the [363] appropriateness of the write down itself, that is, the amount of the write down, it would be necessary for me to be generally satisfied as

to the validity of the basis for the formula. That is, I would have to know more about the circumstances of the company at that particular time, the estimated sales, the condition of the industry, competitive forces, and so on, and those all enter into the determination of the formula.

But based on what I have seen, the approach used was certainly in accordance with generally accepted accounting principles, and one which I and my firm would endorse.

Mr. Berens: Off the record for a moment, Your Honor.

(Whereupon, a discussion was had off the record.)

Mr. Berens: No further questions on direct.

Cross Examination by Mr. Sherman.

Q. Mr. Weston, did I understand you to testify that where it is determined that there is excess inventory being carried on the books, that this excess should be written down in the year in which the excess is determined?

[364] A. I said in the year determined. In most cases that would also be the year in which the excess was created or first existed, if you will. In other words, I didn't mean to imply that a corporation could disregard excess inventories, and then finally in one year determine that there was excess. I was implying that a determination or a review would be made each year, and in that sense I used the determination as being the year in which it, in fact, first existed. I didn't mean to imply that you could defer making a determination.

Q. Well, if, in fact, the excess was not created in the particular year involved, but had existed in a prior year, what would the treatment of such excess be on the basis of generally accepted accounting principles in the year—

A. In which year?

Q. In the year in which this excess was determined or discovered, although it was subsequent to the year in which it was created.

A. You mean in Year One, there was, in fact, an excess?

Q. That is correct.

A. But it was not recognized or recorded as such for accounting purposes?

[365] That is correct.

A. In Year Two there was a determination made that there was an excess which was overlooked in Year One?

Q. Either overlooked or—or intentionally not written down. Take either of those situations. If your answer would be different in one case as opposed to the other, then give me the answer to each of those two different possibilities.

A. Well, we are in a rather complex area in which the accounting results are somewhat complex. If the management, and this has to do with estimation of inventories—I mentioned earlier estimates of inventories, accounts receivable, the nature of items where a determination of values are imprecise and based on estimates and so on, if we assume at the end of Year One that management in good faith had made an estimate or a determination of excess and obsolescence, then under our accounting rules that determination stands, made in good faith, and any subsequent adjustments of those estimates fall when the adjustments are determined or come to light.

Now, the crunch part of your question is: Was an estimate as to excess inventories made in good faith at the end of Year One, and I will ask you [366] to clarify the question on that point.

Q. Well, let us assume that there was excess inventory in Year One, and that it was not—it was not discovered. But upon subsequent discovery in Year Two, it becomes apparent that the same condition did exist in Year One.

A. Well, we have some accounting literature that describes that as a correction of an error, the omission of information, the misuse of information. But assuming that any one of those three might have occurred, then our generally accepted accounting rules say, and this is contained in Opinion No. 20 of the

Accounting Principles Board, which was issued fairly recently, that opinion states that correction of an error should, in fact, be rolled back to the year in which the—in your case—the excess inventory did, in fact, occur.

Mr. Sherman: No further questions.

Redirect Examination by Mr. Berens.

Q. Taking up Counsel's hypothetical, if that was not an error but a mistake in estimate, what would the accounting treatment be?

A. That implies or infers that management did make a determination and present—presumably their [367] auditors reviewed it. If there is no evidence that that was an error, a misuse of information, that it was in good faith and determined it was a bona fide estimate based upon the best knowledge available, then any subsequent difference or any change in the determination of excess inventories falls in the subsequent periods as a part of this general theory that we are always estimating things every time we close the accounts, and we can't continually go back and change prior figures as long as the original estimates are made to determine fair value on a reasonable basis.

Q. Then in his example, that would belong to Year Two if it were a correction of an honest estimate?

A. Yes. If a bona fide estimate were made at the end of Year One, then any subsequent adjustments in a sense become a Year Two charge.

Q. In the practice of accounting, are there any practical presumptions that the independent auditor gives to management in evaluating whether the earlier year—earlier year's estimate was an error or just a mistake in estimate?

A. Well, this depends in part, of course, on whether the auditor was, in fact, the auditor at [368] end of Year One. If he were at that time the auditor, he would be on the scene, and would be, through his auditing procedures, determining whether appropriate consideration was being given to such questions as excess inventories. He is on the scene at that time

and makes up his mind at the time the accounts for Year One are closed.

So in terms of his own position, and management's, the management makes the first determination. He then reviews that, and assuming as I gather you do, that he is then satisfied with that determination, then he would not raise a question subsequently that a revision in the estimate made in good faith would require any adjustment of the prior period.

Q. And if in the first year, as to the excess inventory, the auditor had given an unqualified opinion, would he be more or less required the second year to accept that as a change in estimate and belonging to that particular year?

A. Well, the assumption that he gave a qualified opinion that—

Q. I said "unqualified."

A. (Continuing) unqualified opinion assumes that he was satisfied with respect to the inventory [369] valuation, and assumes the amounts were material in the absence of some evidence of error or purpose from this statement, he would not be inclined to ask management to change those earlier figures.

Q. You used the words "would not be inclined"—

A. Well, that's probably a professional over-simplification. He would probably resist any change absent evidence of that —that there was an error or a direct misstatement, based on the facts available.

Q. You say he would resist any change? He would attribute that, then, to the second—to the year number two?

A. Yes.

Q. Now, you refer—you have qualified each time that unless there was an error and/or misstatement; to what degree would he require that error to be evident as a practical matter?

A. Well, I am not sure that there are degrees of satisfaction as to whether an error exists or not. He would examine the evidence as to the possibilities of error, and would form his opinion

as to whether this difference was, in fact, an error, or was a difference in opinion, or an error in judgment in that sense. [370] That is very difficult to describe the gradations of judgment involved in determining whether something is in error or a managemental—a management mistake, let's say.

Q. Well—

A. An error in estimate is what I mean.

Q. Perhaps I can phrase the question this way: If he had given an unqualified opinion the first year, as a matter of practice would he be inclined to give management the benefit of the doubt as to what year the excess arose?

A. Well, in the first case, having examined the financial statements at the end of Year One, he was, in fact, satisfied that the inventory was properly stated and presumably followed auditing procedures with respect to inventory, so that from his professional opinion it was clear that he was satisfied the inventories were properly stated at the lower of cost or market.

Now, if something occurred in a subsequent year which would raise questions as to the validity of that determination of inventories at the end of Year One, he would assess those circumstances and attempt to determine whether there was, in fact, a change in circumstance, a reasonable development [371] which indicated the original estimates were not proper in terms of estimates or, in fact, a mechanical error such as someone dropping an inventory page on the floor and not binding it into the final inventory, or a definite intentional misstatement. It would be unlikely, in my view, that either of the latter two would occur to a material degree in a balance sheet certified to by a large accounting firm, and that is why I say there would be less—in my view, at least, less indication or inclination, which was the word I used, to consider a possibility of an error, although I wouldn't rule it out completely.

Mr. Berens: All right. No further questions on redirect.

The Court: Mr. Sherman?

Mr. Sherman: No further questions, Your Honor.

The Court: I have a couple of questions I would like to ask.

Examination by the Court.

Q. Let's say you are performing an audit on a corporation and you find an adjustment at the ending inventory for excess inventory. Do you have any standards, or do you have any guidelines as to how [372] large that adjustment would have to be in relation, say, to gross income or sales, or other items going into the company's expense statement which would cause you to inquire as to the inventory procedures for the beginning of that year, or let's say the inventory procedures for the end of the preceding year?

A. You have changed the question at the very end. I thought you were talking about the materiality of that item with respect to the closing inventory, but you are stipulating a discovery of a fact or a condition in connection with the year-end inventory which might raise questions as to whether those conditions existed at the beginning of the year.

Q. Well, I am getting at this: Let's say you find a large adjustment at the end of the year, a write down by reason of excess inventory. Now, do you have any guidelines as to how large that write down must be before you will inquire into the inventory procedures for the end of the preceding year in order to determine whether part of that—that write down should have been in the previous year?

A. Well, it would be my view that any inventory adjustment which is based on an indication of excess, slow moving, obsolete or damaged inventory, which is of such size that—well, we use the term [373] "material" in accounting—that it is material enough to cause the auditor to question the inventory accounting and production control procedures of the company would, in fact, give rise to this question as to whether a similar condition existed at the beginning of the year.

Now, as I indicated earlier, the question is somewhat complicated by an assumption as to whether the same auditor made the examination at the beginning of the year. If he were there at the

beginning of this year, or the end of Year One, as we were using in the example, then he presumably went through these inventory evaluation procedures.

Having done that, and done it well, then at the end of the year he really should be in for no surprises, and I would be surprised if, for example, he suddenly determined that the company had a stock of spare parts for an automobile which was equal to six years' sales. It would be hard to believe, particularly if that were an older model, that those were all produced during this year.

And then I am sure he would say, "Well, what about last year? What was the status of those items last year?"

So he would certainly, if he were auditing [374] this company for the first time, and other auditors had been involved in the previous year, this would be a very serious question, and there are some cases in which there are disagreements, in fact, as to when obsolescence or excess conditions or obsolete or damaged merchandise, when that, in fact occurred. It is not uncommon involving large companies occasionally.

But, assuming that the same auditor were there at each year-end, then as I say, he would not expect to have—in terms of how large this adjustment should be, that is difficult to state. Inventories, as you can appreciate, are basically broken down by locations. They are broken down by categories. The difference between one location this year and next might be significant for that location, but not in total.

So as in many areas of accounting, we don't have any materiality guideline, and we have been criticized for not having it. But there isn't any rule of thumb that you can say if the inventory adjustment is more than 10 per cent of this year, that is a red flag and then you should go back to last year.

I would think if it were more than ten years and it involved an indication that the inventory [375] at the end of Year Two were, in fact, excess and of the type I mentioned, more than three or four years' supply on an item which was really becoming obsolete or becoming a second-rate product, then the auditor just has to go back and look, even if he did the audit.

I think in good faith, you do.

The Court: Does this raise any questions that either of you wish to inquire about further?

Mr. Berens: No, Your Honor.

The Court: Very well. Thank you, Mr. Weston. You are excused.

(Witness excused.)

Mr. Berens: The Petitioner rests, Your Honor.

The Court: Thank you.

Thereupon the Petitioner rested his case in chief.

Mr. Sherman: The Respondent rests, Your Honor.

The Court: Very well.

Thereupon the Respondent rested his case in chief.

* * *

[384] Mr. Berens: Your Honor, Counsel and I discussed the possibility of seeing if during the briefing period we could stipulate to the so-called year that the excess arose, should that become relevant. They said on some of the expert testimony, it may not be relevant at all.

If our efforts are going to be stipulated to, Counsel has a very high work load, and I would like to—and he may be hard pressed to do it; we seem to have more people available. I don't want to get him in a position where we are claiming we would and he wouldn't. You may have the whole case before you before you decide it.

Mr. Sherman: I would point out, though, that I think an aspect of the case also is to show— [385] Petitioner has this theory with respect to how much of the inventory as of the end of 1964 was in the inventory at various periods, or how much of it became excess at various prior periods.

I think it would be also relevant to show for this same purpose—I don't believe that the Court couldn't decide this case fully without it. If it decided for the Petitioner on the basic question of use of this method and the change of the accounting, I think it would also be necessary to show the effect that the

application of the same procedures would have had at the beginning of the year, and I have already had the revenue agent who is now assigned to the case who, incidentally, is neither of the agents who had previously been involved with the case—they are both retired now—I have asked him to contact Mr. Allen and—so the matter of expediting this is in his hands, and I have done as much as I can towards getting this information obtained and stipulated to as soon as we possibly can.

The Court: Well, the Court appreciates any efforts you can make to stipulate to it, because you say you have adequate personnel right now, but the Court is kind of short of personnel right now. We have two vacancies on the Court, so anything you [386] can do to make it unnecessary to have a further trial in the case will be greatly appreciated.

*　　*　　*

Petitioner's Exhibit 13

THOR POWER TOOL DIVISION & C.R.M.Co.

SPECIAL RESERVE FOR EXCESS INVENTORY VALUATION

December 31, 1964

	Description of Inventory	Gross Usable Inventory*/	Special Reserve: % of Usable Inv.	Special Reserve: Amount	
Speedway					
	Raw Material	$ 90,767	10%	$ 9,077	
	Tool Parts - Code 31	445,609	5	22,280	
	Hardware - Code 33	69,075	50	34,537	
	Motor Parts - Code 35	81,214	5	4,061	
	Manuals & Nameplates Code 75	31,275	10	3,127	
	Work-in-Process	487,505	10	48,750	
		$1,205,455		$121,832	
Cincinnati Rubber					
	Raw Material	$ 89,000	10	$ 9,000	**/
	Work-in-Process	126,000	10	13,000	**/
	Finished Goods	170,000	10	17,000	
		$ 385,000		$ 39,000	

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

**/ Reserve provisions at Cincinnati Rubber rounded to nearest thousands.

Petitioner's Exhibit 14

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF DECEMBER 31, 1964

		Inventory Supply- Based on Prior Year's Usage				Valuation Reserves				
	Gross Usable Inventory */	1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Based on Formula	Special	Total	% of Reserve	Net Usable Inventory
Thor Power Tool Division										
Raw Material	$ 531,202	$ 490,447	$ 12,577	$ 6,731	$ 21,447	$ 32,783	$ 9,077	$ 41,860	3.9	$ 489,342
Completed Parts & Accessories	4,508,601	3,692,020	186,748	86,646	543,187	701,547	64,005	765,552	70.9	3,743,049
Work-in-Process	1,478,927	1,454,152	8,955	5,590	10,230	18,900	48,750	67,650	6.3	1,411,277
Finished Goods, other than Parts & Accessories	1,821,210	1,617,249	68,818	26,620	108,523	162,898	-	162,898	15.1	1,658,312
Total	8,339,940	7,253,868	277,098	125,587	683,387	916,128	121,832	1,037,960	96.2	7,301,980
Cincinnati Rubber Division										
Raw Material	96,000	95,571	50	50	329	392	9,000	9,392	.9	86,608
Work-in-Process	126,000	126,000	-	-	-	-	13,000	13,000	1.2	113,000
Finished Goods	169,273	167,122	626	485	1,040	1,717	17,000	18,717	1.7	150,556
Total	391,273	388,693	676	535	1,369	2,109	39,000	41,109	3.8	350,164
Total Usable Inventory */	$8,731,213	7,642,561	277,774	126,122	684,756					
Valuation Reserves										
Formula		-0-	50%	75%	100%					
Amount		$ -0-	$138,887	$ 94,594	$684,756	$918,237	$160,832	$1,079,069	100.0	
Net Usable Inventory										$7,652,144

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: May 19, 1972

Petitioner's Exhibit 15

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF DECEMBER 31, 1965

	Gross Usable Inventory *	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 489,263	$ 374,571	$ 2,234	$ 1,485	$ 110,973	$ 113,207	8.2	$ 376,056
Completed Parts and Accessories	4,027,841**	2,869,131**	155,866**	98,268**	904,576**	1,056,210**	76.1	2,971,631**
Work-in-Process	574,354**	487,454**	-	-	86,900**	86,900**	6.3	487,454**
Finished Goods, other than Parts and Accessories	1,862,995	1,707,970	55,306	33,853	65,866	118,909	8.5	1,744,086
Total	6,954,453	5,439,126	213,406	133,606	1,168,315	1,375,226	99.1	5,579,227
Cincinnati Rubber Division								
Raw Material	98,854	98,854	-	-	-	-	-	98,854
Work-in-Process	105,701	105,701	-	-	-	-	-	105,701
Finished Goods	149,728	137,176	-	-	12,552	12,552	.9	137,176
Total	354,283	341,731	-	-	12,552	12,552	.9	341,731
Total Usable Inventory *	$7,308,736	5,780,857	213,406	133,606	1,180,867			
Valuation Reserves								
Formula		-0-	50%	75%	100%			
Amount		$ -0-	$106,703	$100,208	$1,180,867	$1,387,778	100.0	
Net Usable Inventory								$5,920,958

* Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Insufficient data are available to accurately separate inventories and reserves between "Completed Parts and Accessories" and Work-in-Process" for the years 1965 and 1966. The allocation of inventories and reserves between these two categories is based on average actual experience for 1967 through 1971.

Prepared May 19, 1972

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES AND VALUATION RESERVES AS OF DECEMBER 31, 1966

	Gross Usable Inventory *	Inventory Supply-Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 470,000	$ 313,333	$ 60,000	$26,667	$ 70,000	$ 120,000	9.4	$ 350,000
Completed Parts and Accessories	4,532,988**	3,594,420**	67,666**	39,319**	831,583**	894,905**	69.7	3,638,083**
Work-in-Process	646,386**	548,588**	-	-	97,798**	97,798**	7.6	548,588**
Finished Goods, other than Parts and Accessories	2,240,420	2,055,691	86,894	30,873	66,962	133,564	10.4	2,106,856
Total	7,889,794	6,512,032	214,560	96,859	1,066,343	1,246,267	97.1	6,643,527
Cincinnati Rubber Division								
Raw Material	123,763	121,411	-	-	2,352	2,352	.2	121,411
Work-in-Process	106,017	105,910	-	-	107	107	-	105,910
Finished Goods	160,343	125,354	-	-	34,989	34,989	2.7	125,354
Total	390,123	352,675	-	-	37,448	37,448	2.9	352,675
Total Usable Inventory*	$8,279,917	6,864,707	214,560	96,859	1,103,791			
Valuation Reserves								
Formula		-0-	50%	75%	100%			
Amount		$ -0-	$107,280	$72,644	$1,103,791	$1,283,715	100.0	
Net Usable Inventory								$6,996,202

* Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Insufficient data are available to accurately separate inventories and reserves between "Completed Parts and Accessories" and Work-in-process" for the years 1965 and 1966. The allocation of inventories and reserves between these two categories is based on average actual experience for 1967 through 1971.

Prepared: May 19, 1972

Petitioner's Exhibit 23

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1967

	Gross Usable Inventory*/	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 466,358	$ 374,039	$ -	$ -	$ 92,319	$ 92,319	4.7	$ 374,039
Completed Parts and Accessories	5,242,161	3,477,082	430,271	242,076	1,092,732	1,489,425	75.9	3,752,736
Work-in-Process	561,957	435,000	-	-	126,957	126,957	6.5	435,000
Finished Goods, other than Parts and Accessories	1,541,519	1,279,344	81,590	45,190	135,395	210,082	10.7	1,331,437
Total	7,811,995	5,565,465	511,861	287,266	1,447,403	1,918,783	97.8	5,893,212
Cincinnati Rubber Division								
Raw Material	127,173	124,997	-	-	2,176	2,176	.1	124,997
Work-in-Process	98,994	98,994	-	-	-	-		98,994
Finished Goods	146,984	105,396	-	-	41,588	41,588	2.1	105,396
Total	373,151	329,387	-	-	43,764	43,764	2.2	329,387
Total Usable Inventory */	$8,185,146	5,894,852	511,861	287,266	1,491,167			
Valuation Reserves								
Formula		-	50%	75%	100%			
Amount		$ -	$ 255,930	$ 215,450	$1,491,167	$1,962,547	100.0	
Net Usable Inventory								$6,222,599

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: June 20, 1972

Petitioner's Exhibit 24

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1968

	Gross Usable Inventory */	Inventory Supply- Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 415,568	$ 339,505	$ -	$ -	$ 76,063	$ 76,063	3.8	$ 339,505
Completed Parts and Accessories	4,993,909	3,083,310	423,772	242,769	1,244,058	1,638,021	81.7	3,355,888
Work-in-Process	447,016	364,807	-	-	82,209	82,209	4.1	364,807
Finished Goods, other than Parts and Accessories	1,563,927	1,336,570	92,207	43,528	91,622	170,372	8.5	1,393,555
Total	7,420,420	5,124,192	515,979	286,297	1,493,952	1,966,665	98.1	5,453,755
Cincinnati Rubber Division								
Raw Material	128,062	128,062	-	-	-	-		128,062
Work-in-Process	108,810	108,810	-	-	-	-		108,810
Finished Goods	145,675	108,249	-	-	37,426	37,426	1.9	108,249
Total	382,547	345,121	-	-	37,426	37,426	1.9	345,121
Total Usable Inventory */	$7,802,967	5,469,313	515,979	286,297	1,531,378			
Valuation Reserves								
Formula		-	50%	75%	100%			
Amount		$ -	$ 257,990	$ 214,723	$1,531,378	$2,004,091	100.0	
Net Usable Inventory								$5,798,876

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: June 20, 1972

Petitioner's Exhibit 25

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1969

	Gross Usable Inventory*/	Inventory Supply-Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Formula Valuation Reserve	% of Reserve	Net Usable Inventory
Thor Power Tool Division								
Raw Material	$ 413,630	$ 366,764	$ -	$ -	$ 46,866	$ 46,866	3.4	$ 366,764
Completed Parts and Accessories	4,212,925	2,899,870	276,850	161,336	874,869	1,134,296	81.9	3,078,629
Work-in-Process	534,616	463,275	-	-	71,341	71,341	5.1	463,275
Finished Goods, other than Parts and Accessories	1,214,889	1,109,895	43,492	25,345	36,157	76,912	5.6	1,137,977
Total	6,376,060	4,839,804	320,342	186,681	1,029,233	1,329,415	96.0	5,046,645
Cincinnati Rubber Division								
Raw Material	172,823	170,413	-	-	2,410	2,410	.2	170,413
Work-in-Process	118,645	117,559	-	-	1,086	1,086	.1	117,559
Finished Goods	157,338	104,921	-	-	52,417	52,417	3.7	104,921
Total	448,806	392,893	-	-	55,913	55,913	4.0	392,893
Total Usable Inventory*/	$6,824,866	5,232,697	320,342	186,681	1,085,146			
Valuation Reserves								
Formula		-	50%	75%	100%			
Amount		$ -	$ 160,171	$ 140,011	$1,085,146	$1,385,328	100.0	
Net Usable Inventory								$5,439,538

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

Prepared: June 20, 1972

Petitioner's Exhibit 26

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF NOVEMBER 30, 1970

		Inventory Supply- Based on Prior Year's Usage				Valuation Reserves				
	Gross Usable Inventory */	1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Based on Formula	Special**	Total	% of Reserve	Net Usable Inventory
Thor Power Tool Division										
Raw Material	$ 512,855	$ 396,451	$ -	$ -	$ 116,404	$ 116,404	$ -	$ 116,404	7.3	$ 396,451
Completed Parts and Accessories	3,953,889	2,489,476	374,839	252,359	837,215	1,213,904	-	1,213,904	76.1	2,739,985
Work-in-Process	749,025	595,928	38,023	47,392	67,682	122,237	-	122,237	7.7	626,788
Finished Goods, other than Parts and Accessories	1,533,787	1,411,472	56,918	12,067	53,330	90,839	6,802**	97,641	6.1	1,436,146
Total	6,749,556	4,893,327	469,780	311,818	1,074,631	1,543,384	6,802	1,550,186	97.2	5,199,370
Cincinnati Rubber Division										
Raw Material	126,629	125,664	-	-	965	965	-	965	.1	125,664
Work-in-Process	101,867	101,867	-	-	-	-	-	-		101,867
Finished Goods	105,922	61,876	-	-	44,046	44,046	-	44,046	2.7	61,876
Total	334,418	289,407	-	-	45,011	45,011	-	45,011	2.8	289,407
Total Usable Inventory */	$7,083,974	5,182,734	469,780	311,818	1,119,642					
Valuation Reserves										
Formula		-	50%	75%	100%					
Amount		$ -	$ 234,890	$ 233,863	$1,119,642	$1,588,395	$ 6,802	$1,595,197	100.0	
Net Usable Inventory										$5,488,777

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Additional reserve required to reduce the inventory of Fast-back drills to estimated net realizable value.

Prepared: June 20, 1972

Petitioner's Exhibit 27

THOR POWER TOOL COMPANY

SUMMARY OF INVENTORIES
AND
VALUATION RESERVES
AS OF OCTOBER 31, 1971

	Gross Usable Inventory */	Inventory Supply— Based on Prior Year's Usage 1-12 Mos.	13-18 Mos.	19-24 Mos.	Over 24 Mos.	Valuation Reserves Based on Formula	Special**	Total	% of Reserve	Net Usable Inventory
Thor Power Tool Division										
Raw Material	$ 409,447	$ 358,635	$ -	$ -	$ 50,812	$ 50,812	$ (226)	$ 50,586	3.3	$ 358,861
Completed Parts and Accessories	3,448,395	2,075,237	293,353	180,204	899,601	1,181,430	25,577	1,207,007	78.7	2,241,388
Work-in-Process	822,593	752,933	-	-	69,660	69,660	(913)	68,747	4.5	753,846
Finished Goods, other than Parts and Accessories	1,250,013	943,335	43,065	28,488	235,125	278,024	(121,811)	156,213	10.1	1,093,800
Total	5,930,448	4,130,140	336,418	208,692	1,255,198	1,579,926	(97,373)	1,482,553	96.6	4,447,895
Cincinnati Rubber Division										
Raw Material	128,161	127,456	-	-	705	705	-	705	0.1	127,456
Work-in-Process	118,993	118,993	-	-	-	-	-	-	-	118,993
Finished Goods	124,398	73,373	-	-	51,025	51,025	-	51,025	3.3	73,373
Total	371,552	319,822	-	-	51,730	51,730	-	51,730	3.4	319,822
Total Usable Inventory */	$6,302,000	4,449,962	336,418	208,692	1,306,928					
Valuation Reserves										
Formula		-	50%	75%	100%					
Amount		$ -	$ 168,209	$ 156,519	$1,306,928	$1,631,656	$ (97,373)	$1,534,283	100.0	
Net Usable Inventory										$4,767,717

*/ Meaning inventory exclusive of that referred to in the last paragraph of Joint Exhibit 7-G.

** Adjustment to the reserve, calculated on a formula basis, required to yield estimated realizable value for the inventory of completed Fast-back drills, hedge trimmers and bench grinders plus their associated parts and materials.

Prepared: June 20, 1972

Petitioner's Exhibit 17

THOR POWER TOOL CO.
ANALYSIS OF
DISPOSITIONS AT
AURORA & LOS ANGELES

Year	Aurora	Los Angeles	Combined
1965	$ 46,769	$ 55,820	$102,589
1966	96,799	39,244	136,043
1967*	848	-0-	848
1968	180,617	11,366	191,983
1969	55,907	64,050	119,957
1970	97,020	15**	97,035
1971	9,467	-0-	9,467
	$487,427	$170,496	$657,922

* Petitioner's factory employees were on strike for approximately 7 months during 1967.

** The Los Angeles Plant was closed in 1970 and its inventory shipped to Aurora.

SUMMARY

1.	December 31, 1964 Inventory Reserve	$1,079,069
2.	Amounts attributable to L.A., Aurora & Branches	846,960
3.	Dispositions at L.A. and Aurora to 12/31/71	657,922

Taking into account only Los Angeles and Aurora, dispositions (line 3) account for nearly 78% of the related reserve provision (line 2) at Los Angeles, Aurora and the Branches.

Petitioner's Exhibit 19

THOR POWER TOOL COMPANY

SUMMARY OF TESTS OF RESERVE

FOR EXCESS INVENTORY BY

ARTHUR ANDERSEN & CO.

	Per AA&Co. Audit Work Papers for Year Ended December 31	
	1970	1971
Number of items tested	150 1/	58 2/
Total reserve for items tested	$ 208,246	$ 214,652
Total Reserve	$1,329,415	$1,550,186
% of total reserve tested	15.7%	13.8%
Net over- (under-) statement of reserve per AA&Co. test	$ (36,711)	$ (9,264)
% reserve understated per AA&Co. test	17.6%	4.3%
Number of items understated	128	44
% of items tested understated	83.3%	75.9%

1/ Items selected for test on the following basis:

(a) 20 largest items in value,
(b) 8 blocks of 10 items, and
(c) 50 items at random.

2/ Items selected for test on the following basis:

(a) All items (18) over $5,000 in "Over 24 Month" column of inventory evaluation list, and

(b) 4 blocks of 10 items.

THOR POWER TOOL COMPANY

SUMMARY OF INCOME STATEMENT
DOMESTIC CONSOLIDATION

Year Ended December 31
(000 omitted)

	1962	1963*	1964*	1965	1966	1967	1968	1969	1970	1971
Net Sales	$30,856	$29,727	$28,422	$25,439	$23,729	$18,752	$17,838	$16,741	$15,093	$13,263
Cost of goods sold	19,878	19,085	22,374	17,945	17,410	14,637	14,436	13,985	12,914	10,871
Gross income	$10,978	$10,642	$ 6,048	$ 7,494	$ 6,319	$ 4,115	$ 3,402	$ 2,756	$ 2,179	$ 2,392
% of net sales	35.6%	35.8%	21.3%	29.5%	26.6%	21.9%	19.1%	16.5%	14.4%	18.0%
Other expenses, net	8,705	9,088	9,084	6,974	6,548	5,945	4,485	4,709	4,702	4,045
% of net sales	28.2%	30.6%	32.0%	27.4%	27.6%	31.7%	25.1%	28.1%	31.2%	30.5%
Dividends from foreign subsidiaries	(265)	(280)	(210)	(202)	(779)	(280)	--	--	--	(2,494)
Income (loss) before income taxes	$ 2,538	$ 1,834	$(2,826)	$ 722	$ 550	$(1,550)	$(1,083)	$(1,953)	$(2,523)	$ 841
% of net sales	8.2%	6.2%	(10.0%)	2.8%	2.3%	(8.3%)	(6.1%)	(11.7%)	(16.7%)	6.3%
Provision (credit) for income taxes	1,165	762	(1,298)	263	39	(67)	--	--	--	--
Net income (loss)	$ 1,373	$ 1,072	$(1,528)	$ 459	$ 511	$(1,483)	$(1,083)	$(1,953)	$(2,523)	$ 841
Net increase (decrease) in reserve for excess inventory		$152**/	$ 927	$ 309	$ (104)	$ 679	$ 41	$ (619)	$ 210	$ (61)

* Prior to restatement

** Balance as of December 31 1963

Petitioner's Exhibit 22

THOR POWER TOOL COMPANY

RESERVE FOR EXCESS AND OBSOLETE INVENTORIES
DOMESTIC CONSOLIDATION

(000 Omitted)

Year Ended Dec. 31	Balance at Beginning of Year	Provision Charged (Credited) to Operations: Excess Inventory	Obsolete Inventory	Total	Dispositions(1)	Balance at End of Year
1964	$ 152	$ 927	$2,684	$ 3,611	$ --	$3,611
1965	3,763	309	581	890	(1,270)	3,383
1966	3,383	(104)	367	263	(452)	3,194
1967	3,194	679	(418)	261	(122)	3,333
1968	3,333	41	118	159	(896)	2,596
1969	2,596	(619)	427	(192)	(438)	1,966
1970	1,966	210	536	746	(594)	2,118
1971	2,118	(61)	365	304	(241)	2,181

(1) Dispositions of excess, obsolete, and damaged inventories, net of proceeds received.

THOR POWER TOOL COMPANY

Analysis of Bad Debt Reserve
Requirement as of
December 31, 1965

Account	Total Receivable	Basis For Reserve	Amount of Reserve	Considered Collectible
Intercompany Accounts	$1,637,263	None	-0-	$1,637,263
Cincinnati Rubber Division	198,149	2 accounts 100% remainder 1%	4,550	193,599
Power Tools Div.				
Current Accounts (0-29 days past due)	1,744,815	1%	17,448	1,727,367
30-59 days past due	589,374	2%	11,787	577,587
60-90 days past due	249,995	2%	5,000	244,995
Over 90 days past due:				
(a) Balances over $100:				
(i) "Hard Core"	161,898*/	100%	161,898	-0-
(ii) Other	358,043	2%	7,160	350,883
(b) Balances under $100:				
(i) "Hard Core"	19,493**/	100%	19,493	-0-
(ii) Other	43,231	2%	865	42,366
Pending Claims For Credits	222,455	---	---	---
Payments Received to 12/31/65	(296,751)	---	---	---
Misc. Adj.	---	---	746	---
TOTALS	$4,927,965	---	$226,947	$4,699,018

*/ Determined by management review of each account in light of currently available credit information and past experience with each debtor. Amount reserved against shown after deduction of pending claims for credit against these accounts.

**/Applied same ratio of "Hard Core" to "Other" as was determined by individual review for accounts over $100.

EXHIBIT 29

DIVISION OF FEDERAL TAXATION
of the
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Comments on the Proposed Regulations
Under Section 471 and Other Related Sections of the
Internal Revenue Code of 1954
Regarding Valuation of Inventories

April 17, 1972

GENERAL COMMENTS

We have mixed reactions about the proposed regulations. On the one hand, we commend the Internal Revenue Service for its effort to develop more definitive rules for the pricing of inventories of manufacturers for tax purposes. On the other hand, we strongly oppose the imposition of "financial statement eligibility tests" and urge that such tests not be made part of any final regulations in this area. Our concern also extends to the definitions and procedures prescribed for cost determination, the proposed transitional rules, the importance of consistency in inventory valuation and valuation matters not presently covered by the proposed regulations.

Opposition to financial statement eligibility tests. The American Insitute of CPAs believes that greater conformity of tax and financial accounting is a desirable goal, but this goal should be achieved without "financial statement eligibility tests." Such tests, which either in fact or in effect provide that an accounting method may be adopted or used for tax purposes only if the same method of accounting is used for financial reporting purposes, may inhibit the development of accounting principles.

It should also be noted that in attempting to achieve the objective of conforming tax and financial accounting, it is in-

consistent for tax accounting rules to be spelled out in such great detail as is the case in these proposed regulations. This detail, in effect, promulgates new accounting principles rather than adopts generally accepted accounting principles, where applicable, for federal income tax purposes.

* * *

Certain valuation matters not covered. An important valuation matter not covered relates to the problem of determining appropriate costs for inventory quantities in excess of prospective demand. This is especially troublesome when such items as repair parts carried to service obsolete models are greater than indicated customer needs. While quantities in excess of anticipated needs could be scrapped and thereby eliminated from inventory values, the cost of producing additional parts, in the event that actual future need is greater than presently estimated, would be prohibitive.

Management of companies, as well as their independent accountants engaged to attest to their financial statements, faced with this problem, are acutely aware of the high order of risk associated with carrying inventories of excess stocks at full cost values. Failure to recover such cost values on inventories carried in anticipation of future sales that do not in fact materialize is one of the most common causes of business failure. Under such circumstances, management is usually reluctant to represent that such excess stocks are worth full value, and their independent accountants are unwilling to accept full cost value in expressing their professional opinion on the financial statements involved. Many companies having such problems have developed methods of inventory valuation for slow-moving or excess stocks which attribute only fractions of the original costs thereto. These practices are generally regarded as appropriate and necessary to take into account the reduced economic values resulting from limited demand. Such inventory write-downs are analogous to adjustments to "market" under the "lower of cost or market" inventory valuation method. Usually, a system of discounting

is developed on a judgmental basis, consistently applied. The result is generally satisfactory for management in carrying out its stewardship and reporting responsibilities, and it is usually acceptable to the company's independent accountants.

Steps should be taken to modify the regulations regarding the valuation of slow-moving or excess stocks in order to recognize the fundamental soundness of applying reductions to those portions of inventories where current information clearly indicates that realization of full cost through ultimate sale is unlikely.

* * *

JOINT EXHIBIT 7-G

Page 5

THOR POWER TOOL COMPANY

U. S. Corporate Income Tax Return
1964

Schedule A—Question 2

The inventories at December 31, 1964 were priced at the lower of cost <first-in, first-out> or market, such inventories are stated on the same basis and were determined generally in the same manner as inventories at December 31, 1963 except that as a result of revision in operating policies made late in 1964, revised procedures were adopted to value excess stock. The valuation of inventories of excess stock at December 31, 1964 was determined generally by reference to usage in the past year and the application of the following percentage write-downs:

50% of that portion of the quantity of an item in excess of 12 months supply.

An additional 25% applied to that portion of the quantity of an item in excess of 18 months supply.

A further write down of 25% applied to that portion of the quantity of an item in excess of 24 months supply.

It is believed that, as a result of the above procedures, the inventory is stated at the lower of cost or market. The resulting percentage write-down totaled $1,079,069.

Old items for which there was no usage in the past year have been obsoleted and charged off.

EXHIBIT P

[THOR POWER TOOL COMPANY]

[1964 ANNUAL REPORT]

[President's Letter to Shareholders]

TO THE SHAREHOLDERS OF
THOR POWER TOOL COMPANY:

* * *

The Company and its subsidiaries incurred a consolidated operating loss of $2,239,454 for the year ended December 31, 1964. After adjustment for the resulting tax effect, the net loss for the year was $1,388,058.

These results are before taking into account an extraordinary charge in the amount of $3,608,052, after giving effect to income tax adjustments. Such extraordinary charge relates principally to excess, obsolete and damaged inventories, and to the provision of additional reserves, more specifically referred to later, against costs and liabilities, and against the values of certain of the Company's other assets.

A portion of the 1964 loss and, to a greater degree, of the extraordinary charge, resulted from changes in accounting practices and principles. (See Note (1) to the financial statements.) Certain of the charges made at the year-end result from the exercise of present management's judgment and discretion and are not susceptible of precise mathematical computation. Your new management believes, and your board of directors concurs, that it was prudent to adopt the more conservative accounting policies and practices which were employed in evaluating the assets and liabilities of the Company at December 31, 1964.

The charges recorded in the Company's books at December 31, 1964 relate to operations up to that time, and it is not expected that they, in and of themselves, will have a favorable effect on Thor's operations from that date forward except that

such future operations will not have to bear the costs of those liabilities against which reserves have now been provided, as they would have had to do under the Company's prior accounting practices.

Thor's loss for 1964 resulted, in large part, from excessive operating costs, including high production costs which, in many instances, were not being accurately measured. An urgent program is being initiated toward the establishment of more effective cost accounting systems. This cannot be accomplished quickly and it will be some time, therefore, before the benefits to be derived from such changes in cost accounting procedures can be realized.

* * *

Net Income

As stated earlier in this report, Thor's 1964 operations resulted in a consolidated net loss (after tax credits) of $1,388,058, before the deduction of an extraordinary charge totaling $3,608,052 (after income tax adjustments).

The extraordinary charge includes a provision for losses from excess, obsolete and damaged inventories, and to reflect in the accounts, at the year end, appropriate reserves for anticipated product warranty and return goods expenses, losses on receivables, the write-off of special tooling and engineering costs which previously had been deferred, compensation of retirees, other liabilities and similar items.

* * *

Arthur R. Collins
President

Aurora, Illinois
April 9, 1965

THOR POWER TOOL COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

December 31, 1964 and 1963

ASSETS

	1964	1963
CURRENT ASSETS:		
Cash	$ 1,343,244	$ 863,506
Receivables, less allowance for doubtful accounts ($230,130 for 1964 and $100,792 for 1963)	5,807,597	6,510,348
Refundable United States income taxes	1,885,800	—
Inventories, priced at lower of standard cost (first-in, first-out) or market:		
Finished products and work in process	7,929,296	12,149,213
Raw materials and supplies	1,293,113	2,124,852
	9,222,409	14,274,065
Prepaid expenses	189,327	254,520
Total current assets	18,448,377	21,902,439
OTHER ASSETS:		
Deferred charges	754,456	625,519
PROPERTY, PLANT AND EQUIPMENT, AT COST:		
Land	375,136	452,036
Buildings	3,832,655	3,568,224
Machinery and equipment	9,378,060	9,357,825
	13,585,851	13,378,085
Less accumulated depreciation	7,994,631	7,540,171
	5,591,220	5,837,914
	$24,794,053	$28,365,872

LIABILITIES

	1964	1963
CURRENT LIABILITIES:		
Bank loans	$ 3,327,170	$ 2,093,517
Current portion of long-term debt	300,000	300,000
Accounts payable	2,507,081	2,301,256
Accrued wages, withholding and other taxes	1,154,091	1,096,044
Other accrued liabilities	1,173,031	248,371
United States and foreign taxes on income (less foreign tax certificates, $247,800 in 1964 and 1963)	404,880	1,177,643
Total current liabilities	8,866,253	7,216,831
OTHER LIABILI[illegible]		
Pensions and deferred payments, net of income taxes	1,311,326	659,705
LONG-TERM DEBT (Note 3):		
4⅞% convertible subordinated debentures due June 1, 1981	4,000,000	4,000,000
4% sinking fund notes payable, $150,000 due annually with final payment in 1971	1,250,000	1,400,000
5¼% sinking fund notes payable, $150,000 due annually with final payment in 1973	1,550,000	1,700,000
	6,800,000	7,100,000
STOCKHOLDERS' EQUITY:		
Capital stock, without par value: (Notes 7 and 8)		
Authorized 2,000,000 shares		
Issued 826,803 shares (before deducting shares held in treasury)	5,326,300	5,326,300
Retained earnings (Note 3)	5,454,473	11,032,585
	10,780,773	16,358,885
Less shares held in treasury, at cost (99,200 shares in 1964 and 99,400 shares in 1963)	2,964,299	2,969,549
	7,816,474	13,389,336
	$24,794,053	$28,365,872

See accompanying notes to financial statements.

STATEMENT OF CONSOLIDATED INCOME

Years Ended December 31, 1964 and 1963

	1964	1963
Net sales	$32,837,908	$33,714,349
Cost of sales	24,802,385	21,665,868
Gross income from sales	8,035,523	12,048,481
Selling and administrative expenses:		
Selling, service and advertising	6,610,818	6,290,391
General and administrative	3,069,399	2,695,819
	9,680,217	8,986,210
Operating income (loss)	(1,644,694)	3,062,271
Other charges:		
Interest	502,564	461,676
Miscellaneous	221,568	29,980
	724,132	491,656
Other income	129,372	87,862
Income (loss) before income taxes	(2,239,454)	2,658,477
Provision for income taxes (credit)	(851,396)	1,313,094
Net income (loss) for the year	(1,388,058)	1,345,383
Extraordinary charge, less tax effect of $2,734,090 (Note 1)	3,608,052	—
Net income (loss) for the year and extraordinary charge in 1964	($4,996,110)	$ 1,345,383

See accompanying notes to financial statements

* * *

NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1964

(1) The accounts of the company at December 31, 1964 reflect certain changes from the accounting practices and principles previously followed. Changes were made in the methods of determining and valuing obsolete and excess inventory. Tooling, and research and development costs, previously amortized over several years, are now being charged to expense as incurred. The accounting for payments under informal pension arrangements was changed from a "pay-as-you-go" method to a modified accrual method, and the company has elected to provide for the cost of past service with respect to the retirement plan for salaried employees over a 30 year period from 1958, the first full year of the plan. The company also has revised its estimates as to the total future payments to be made under deferred compensation arrangements. Reserves have been established for certain estimated expenses, claims and contingencies.

The major effect of the foregoing changes has been shown as an extraordinary charge in the statement of consolidated income for the year ended December 31, 1964.

* * *

ACCOUNTANTS' REPORT*

The Board of Directors
THOR POWER TOOL COMPANY:

We have examined the consolidated balance sheet of Thor Power Tool Company and subsidiaries as of December 31, 1964 and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In view of the unsatisfactory operating results for 1964, the contemplated revisions in operating policies, and for other reasons, the present management of the company has made certain changes in the accounting principles and practices heretofore followed. The nature of these changes is indicated in Note 1 to the financial statements and the major effect of the changes has been reflected as an extraordinary charge in the statement of consolidated income. In part, the amounts allocated to the extraordinary charge are of necessity based on management's estimates and assumptions. While we believe the new procedures to be reasonable in the circumstances, their appropriateness, particularly as they relate to inventory valuation, can only be adequately evaluated in the light of future events.

In our opinion, subject to the comments in the preceding paragraph, the accompanying financial statements present fairly the financial position of Thor Power Tool Company and subsidiaries at December 31, 1964 and the results of their operations

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

for the year then ended, in conformity with generally accepted accounting principles which, except as stated above, have been applied on a basis consistent with that of the preceding year.

PEAT, MARWICK, MITCHELL & CO.

Chicago, Illinois
April 5, 1965

EXHIBIT Q

[THOR POWER TOOL COMPANY]

[1965 ANNUAL REPORT]

[President's Letter to Shareholders]

TO THE SHAREHOLDERS OF
THOR POWER TOOL COMPANY:

* * *

During 1965, the Company terminated its relationship with its former auditors and retained Price Waterhouse & Co., as its independent public accountants.

As stated in our letter to shareholders dated February 25, 1966, the Company recently completed a further investigation in order to attempt to allocate, to specific periods, the 1964 year-end adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits), and to determine the extent to which the previously issued financial statements of the Company should be revised. As a result of this study, the Company filed with the Securities and Exchange Commission, on February 24, 1966, revised financial statements for the years ended December 31, 1964 and December 31, 1963 and for the six months period ended June 30, 1964. The operating results and other financial information for the year 1964 as stated in this annual report reflect the changes resulting from the allocation of the 1964 year-end adjustments to specific periods and conform with the revised statements filed with the Securities and Exchange Commission.

* * *

Net Income

For the year ended December 31, 1965, the Company and its subsidiaries earned a net profit of $293,012 after taxes, equal to $.40 per share of capital stock outstanding at the year-end. This compares with a net loss in 1964 of $1,038,691 ($1,454,955

before applicable income tax credits), prior to the deduction of a special charge of $1,490,051 ($2,632,051 before applicable income tax credits). The 1964 special charge consisted primarily of write-downs for obsolete and excess inventories which could not be allocated to specific periods because adequate information is not now available.

The reallocation of $3,237,859 of the total 1964 year-end adjustments to specific periods, as the result of the study discussed earlier, reduced previously reported earnings for 1962 and prior years by $1,876,494, and earnings for 1963 from $1,345,383 to $754,409. The net loss for 1964 of $1,388,058, before a special charge of $3,608,052, as recorded in the annual report for that year, was reduced to $1,038,691, and the special charge was reduced to $1,490,051. All of these figures are after the applicable income tax effects.

Working Capital

* * *

In 1965, the Company obtained a refund of Federal income taxes in the amount of $2,311,512, resulting from the loss reported for the year 1964, including the special charge. The tax refund together with funds resulting from the Company's profit for the year, provisions for depreciation, and from reductions in inventories and receivables were used to retire the Company's short-term bank loans, to meet $300,000 of maturities on its long-term debt, to pay past due accounts, and to add to working capital—for which there are many urgent needs.

* * *

Litigation

In our report for the first six months of 1965, we informed you that, following an investigation by independent legal counsel of the conduct of the Company's business by the previous management, the Company had filed suit for damages against three former officers and the estate of the deceased former chairman and president. This suit is pending. Its ultimate effect upon the

Company's financial condition is uncertain because the financial resources of the defendants are unknown.

During 1965, two lawsuits were filed against the Company and several other defendants asserting claims based upon the conduct of the business by the previous management. Legal counsel for the Company have informed us that it is not possible to forecast the outcome of this litigation or its ultimate effect on the Company's financial condition because it involves many unsettled legal issues and uncertainties about the facts. However, the Company has been advised by its legal counsel that the Company's cross-claim against its former independent public accountants, who also are defendants in these lawsuits, has substantial merit, and that if the Company should be held liable in these lawsuits, it should prevail in its cross-claim for the amount of its liability.

* * *

ARTHUR R. COLLINS
President

Aurora, Illinois
March 31, 1966

THOR POWER TOOL COMPANY AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

December 31, 1965 and 1964

ASSETS

	1965	1964
CURRENT ASSETS:		
Cash and marketable securities (at cost)	$ 3,196,858	$ 1,343,244
Receivables, less allowance for doubtful accounts ($285,390 in 1965 and $230,130 in 1964)	4,479,154	5,807,597
Refundable United States income taxes (Note 3)	—	2,457,312
Inventories, priced at lower of standard cost (first-in, first-out) or market (Note 2):		
Finished products and work in process	6,600,504	8,519,578
Raw materials and supplies	533,323	702,831
	7,133,827	9,222,409
Prepaid expenses	137,651	189,327
Total current assets	14,947,490	19,019,889
OTHER ASSETS:		
Deferred charges	125,065	182,944
PROPERTY, PLANT AND EQUIPMENT, AT COST:		
Land	372,569	375,136
Buildings	3,914,279	3,832,655
Machinery and equipment	9,478,882	9,378,060
	13,765,730	13,585,851
Less accumulated depreciation	8,360,695	7,994,631
	5,405,035	5,591,220
	$20,477,590	$24,794,053

LIABILITIES

	1965	1964
CURRENT LIABILITIES:		
Bank loans	$ —	$ 3,327,170
Current portion of long-term debt	300,000	300,000
Accounts payable	634,697	2,507,081
Accrued wages, withholding and other taxes	1,068,811	1,154,091
Other accrued liabilities	1,353,259	1,173,031
United States and foreign taxes on income (less foreign tax certificates, $56,000 in 1965 and $247,800 in 1964)	1,124,134	404,880
Total current liabilities	4,480,901	8,866,253
OTHER LIABILITIES:		
Pensions and deferred payments, net of income taxes	1,387,203	1,311,326
LONG-TERM DEBT (Note 5):		
4⅞% convertible subordinated debentures due June 1, 1981	4,000,000	4,000,000
4% sinking fund notes, payable $150,000 annually with final payment in 1971	1,100,000	1,250,000
5¼% sinking fund notes, payable $150,000 annually with final payment in 1973	1,400,000	1,550,000
	6,500,000	6,800,000
SHAREHOLDERS' EQUITY:		
Capital stock, without par value (Notes 5 and 8): Authorized 2,000,000 shares; Issued 826,803 shares (before deducting shares held in treasury)	5,326,300	5,326,300
Retained earnings (Note 5)	5,747,485	5,454,473
	11,073,785	10,780,773
Less 99,200 shares held in treasury, at cost	2,964,299	2,964,299
	8,109,486	7,816,474
	$20,477,590	$24,794,053

The accompanying notes to the consolidated financial statements are an integral part of these statements.

NOTES TO FINANCIAL STATEMENTS
AT DECEMBER 31, 1965

(1) A thorough assessment of the affairs of the Company and a careful evaluation of its assets and liabilities at December 31, 1964 resulted in adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits) being reported in the Company's consolidated statements of income and retained earnings as of December 31, 1964. These adjustments were recorded in the 1964 statement of consolidated income (as it appeared in Thor's 1964 Annual Report), $1,119,858 being charged to 1964 operations and $3,608,052 being recorded as a special charge after net loss for the year. The allocation of the adjustments, as between 1964 operations and the special charge, was based upon the information that was then available. No attempt was made at that time to allocate these adjustments to specific prior periods.

As explained more fully in a letter to shareholders, dated February 25, 1966, the Company made a further study in order to attempt to allocate the 1964 year-end adjustments to specific periods. The reallocation of the 1964 year-end adjustments, which remained unchanged in total, to certain specific prior periods resulted in a reduction in earnings for 1962 and prior years of $1,876,494. Also, the previously reported earnings for 1963 were reduced from $1,345,383 to $754,409, and the reported 1964 loss of $1,388,058, before the special charge, was reduced to $1,038,691. The allocation of a portion of the year-end adjustments to specific periods reduced the special charge from $3,608,052, as reported in the 1964 Annual Report, to $1,490,051, representing adjustments that could not be allocated to specific periods because of insufficient supporting data. The accompanying comparative financial statements for 1964

have been restated to reflect the reallocation of 1964 year-end adjustments to specific periods.

(2) A substantial portion of the 1964 year-end adjustments represented provisions for losses from excess, obsolete and damaged inventories. During 1965, a portion of the obsolete and damaged inventories was physically disposed of, and the reserve for excess and obsolete inventory at the year end, after an additional 1965 provision of $1,051,000, reflects anticipated future requirements based on the Company's present marketing plans. The inventories shown on the accompanying balance sheets are stated net of reserves of $3,903,725 and $4,382,588 at December 31, 1965 and 1964, respectively.

* * *

(9) During 1965, two lawsuits were filed against the Company and several other defendants asserting claims based upon the conduct of the business by the previous management. Legal counsel for the Company have informed us that it is not possible to forecast the outcome of this litigation or its ultimate effect on the Company's financial condition because it involves many unsettled legal issues and uncertainties about the facts. However, the Company has been advised by its legal counsel that the Company's cross-claim against its former independent public accountants, who also are defendants in these lawsuits, has substantial merit and that if the Company should be held liable in these lawsuits it should prevail in its cross-claim for the amount of its liability.

Following an investigation, early in 1965, by independent legal counsel of the conduct of the Company's business by the previous management, the Company filed suit for damages against three former officers and the estate of the deceased former chairman and president. The ultimate effect of this lawsuit upon the Company's financial condition is uncertain because the financial resources of the defendants are unknown.

OPINION OF INDEPENDENT ACCOUNTANTS*

To the Board of Directors of
THOR POWER TOOL COMPANY:

We have examined the consolidated balance sheet of Thor Power Tool Company as of December 31, 1965 and the related statements of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The financial statements at December 31, 1964 were examined by other independent accountants, whose opinion dated April 5, 1965 was subject to the appropriateness of certain changes made during 1964 in accounting principles and practices, particularly as they are related to inventory valuation, which, while considered by them to be reasonable in the circumstances, could only be evaluated in the light of future events.

As explained in Note 2, substantial provisions were made in 1964 and 1965 to reduce certain inventories, considered by management to represent obsolete, damaged and excess stocks, to their estimated realizable value. While the reserves provided reflect the best current judgment of the company's management, it is not possible to evaluate these reserves prior to the ultimate disposition of the inventories involved.

In our opinion, subject to the effect of the ultimate adjustments arising from the disposition of the inventories referred to above, and subject to the final outcome of the pending litigation described in Note 9, the accompanying consolidated financial

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

statements present fairly the financial position of Thor Power Tool Company and its subsidiaries at December 31, 1965, and the results of their operations for the year, in conformity with generally accepted accounting principles. These principles were applied on a basis consistent with that of the preceding year, the financial statements for which were restated by the Company as described in Note 1.

PRICE WATERHOUSE & CO.

Chicago, Illinois
March 25, 1966

EXHIBIT R

[THOR POWER TOOL COMPANY]

[S.E.C. FORM 10-K]

[For the Fiscal Year Ended 1964]

* * *

ACCOUNTANTS' REPORT*

The Board of Directors
Thor Power Tool Company

We have examined the consolidated financial statements and related schedules of Thor Power Tool Company and subsidiaries as listed in the accompanying index. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In view of the unsatisfactory operating results for 1964, the contemplated revisions in operating policies and for other reasons, the present management of the company has made certain changes in the accounting principles and practices heretofore followed. The nature of these changes is indicated in note 1 to the financial statements and the major effect of the changes has been reflected as an extraordinary charge in the statement of consolidated income. In part, the amounts allocated to the extraordinary charge are of necessity based on management's estimates and assumptions. While we believe the new procedures to be reasonable in the circumstances, their appropriateness, particularly as they relate to inventory valuation, can only be adequately evaluated in the light of future events.

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

In our opinion, subject to the comments in the preceding paragraph, such financial statements present fairly the financial position of Thor Power Tool Company and subsidiaries at December 31, 1964 and the results of their operations for the year then ended, in conformity with generally accepted accounting principles which, except as stated above, have been applied on a basis consistent with that of the preceding year; and the supporting schedules, in our opinion, present fairly the information required to be stated therein.

PEAT, MARWICK, MITCHELL & CO.

Chicago, Illinois
April 5, 1965

Notes to Financial Statements
December 31, 1964

1. Changes in Accounting Practices and Principles:

The Accounts of the company at December 31, 1964 reflect certain changes from the accounting practices and principles previously followed. Changes were made in the methods of determining and valuing obsolete and excess inventory. Tooling and research and development costs, previously amortized over several years, are now being charged to expense as incurred. The accounting for payments under informal pension arrangements was changed from a "pay-as-you-go" method to a modified accrual method and the company has elected to provide for the cost of past service with respect to the retirement plan for salaried employees over a 30-year period from 1958, the first full year of the plan. The company also has revised its estimates as to the total future payments to be made under deferred compensation arrangements. Reserves have been established for certain estimated expenses, claims and contingencies.

The major effect of the foregoing changes has been shown as an extraordinary charge in the statement of consolidated income.

* * *

3. Inventories:

The inventories, priced at the lower of standard cost (first-in, first-out) or market, used in the computation of cost of sales for 1964 and, in part, the extraordinary charge, were as follows:

December 31, 1964	$ 9,222,409
December 31, 1963	14,238,482

As of December 31, 1964 the company, under new management, revised its methods and procedures with respect to

the determination of obsolete and excess quantities of inventories. A portion of the resulting charge has been allocated to the extraordinary charge. See note 1.

* * *

EXHIBIT S

[THOR POWER TOOL COMPANY]

[S. E. C. FORM 8]

[Amending Form 10-K for the Year Ended December 31, 1964]

* * *

Exhibit A

THOR POWER TOOL COMPANY

Introductory Statement

Explanation of Revisions to Financial Statements Filed in Form 8

As a result of the events relating to the rescission of a purchase and sale agreement dated August 20, 1964, with Stewart-Warner Corporation, Thor's present management conducted extensive investigations, and determined that adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits) should be made to consolidated income and retained earnings as of December 31, 1964. These adjustments were recorded in the 1964 statement of consolidated income, $1,119,858 being charged to 1964 operations, and $3,608,052 being recorded as a special charge after net loss for the year. The allocation of the adjustments as between 1964 operations and the special charge was based upon information that management was able to obtain in the limited time available. No attempt was made at that time to allocate these adjustments to specific prior periods.

In order to amend certain reports previously filed with the Securities and Exchange Commission, a further study has been made in order to allocate these adjustments, which remain unchanged in total, to certain specific periods, wherever deter-

minable, as follows: (a) the year ended December 31, 1964, (b) the six months ended June 30, 1964, (c) the year ended December 31, 1963, and (d) 1962 and prior periods. No audit has been made of the data which were accumulated and used as a basis for the allocations to periods.

As a result of this study, the 1964 year-end adjustments have been divided into three classifications as follows:

1. Adjustments, other than those related to changes in the application of generally accepted accounting principles, which can be allocated to periods on the basis of information obtained by the current study ($3,956,000 before income tax credits and $2,201,000 after income tax credits).

In determining the allocations of the adjustments to periods, prior periods have not been charged with adjustments resulting from operating decisions made by the present management.

A significant portion of the adjustments which are shown as applicable to the six months ended June 30, 1964, represents a pro rata allocation on a monthly basis of certain adjustments determined as applicable to the year 1964.

See Note 1 of page 5 of this Exhibit for further details with respect to these adjustments.

2. Adjustments related to changes in the application of generally accepted accounting principles ($1,872,000 before income tax credits and $1,037,000 after income tax credits).

Certain of the adjustments reflected changes in the application of generally accepted accounting principles (which management in each case considered a more realistic practice in the circumstances). All of these changes have been retroactively allocated to periods as if the alternative accounting practices selected by the present management had been in effect during those periods.

See Note 2 on page 8 of this Exhibit for further details with respect to these adjustments.

3. Adjustments not allocated to periods ($2,632,000 before income tax credits and $1,490,000 after income tax credits).

These adjustments, which consist primarily of write-downs for obsolete and excess inventories, may relate to several periods. The limited information available does not provide an adequate basis for allocation to any specific period, and accordingly these adjustments have been classified as a special charge after net loss for 1964.

The tabulations which follow summarize the adjustments by the three classifications previously described, and set forth the effects of the allocations of the adjustments described in (1) and (2) above on net income and retained earnings reported in prior periods.

A summary of the adjustments by classifications as described above and of the results of the allocations is set forth below:

	Total Adjustment		Allocate Adjustments, Other Than Changes in the Application of Generally Accepted Accounting Principles		Changes in the Application of Generally Accepted Accounting Principles		Adjustments Not Allocated to Periods	
	Before Tax Credits	After Tax Credits	Before Tax Credits	After Tax Credits	Before Tax Credits	After Tax Credits	Before Tax Credits	After Tax Credits
				(In Thousands)				
Allocated to year ended December 31—								
1964	$1,344	$ 770	$1,119	$ 628	$ 225	$ 142	$ —	$ —
1963	1,039	591	820	471	219	120	—	—
1962 and prior	3,445	1,877	2,017	1,102	1,428	775	—	—
Not allocated	2,632	1,490	—	—	—	—	2,632	1,490
	$8,460	$4,728	$3,956	$2,201	$1,872	$1,037	$2,632	$1,490
Allocated to six months ended June 30, 1964	$1,459	$ 762	$1,277	$ 661	$ 182	$ 101	$ —	$ —

The effect on the net income and retained earnings reported in prior periods of the allocations discussed above is as follows:

	Total Adjustment	Year Ended December 31, 1964: Net (Loss) for the Year	Year Ended December 31, 1964: Special Charge	Net Income for Year Ended Dec. 31, 1963	Retained Earnings at Dec. 31, 1962	Net Income (Loss) for Six Months Ended June 30, 1964 (Memo)
			(In Thousands)			
As reported	$(4,728)	$(1,388)	$(3,608)	$1,345	$10,850	$ 613
To reverse 1964 year-end adjustments as recorded	4,728	1,120	3,608	—	—	—
	$ —	$ (268)	$ —	$1,345	$10,850	$ 613
Adjustments allocated to specific periods (excluding adjustments for changes in the application of generally accepted accounting principles) (Note 1)	(2,201)	(628)	—	(471)	(1,102)	(661)
Restated for adjustments allocated to specific periods (before changes in the application of generally accepted accounting principles)	$(2,201)	$ (896)	$ —	$ 874	$ 9,748	$ (48)
Adjustments resulting from changes in the application of generally accepted accounting principles (Note 2)	(1,037)	(142)	—	(120)	(775)	(101)
Restated for all adjustments allocated to specific periods	$(3,238)	$(1,038)	$ —	$ 754	$ 8,973	$(149)
Adjustments not allocated to periods (Note 3)	(1,490)	—	(1,490)	—	—	—
As restated	$(4,728)	$(1,038)	$(1,490)	$ 754	$ 8,973	$(149)

Notes:

(1) Adjustments allocated to specific periods, excluding adjustments for changes in the application of generally accepted accounting principles, consisted principally of the following (amounts shown are before income tax credits):

	Total Adjustment Allocated to Periods
a. Provisions for losses on damaged inventories of $422,000 and obsolete inventories of $447,000. The damaged inventories consisted primarily of defective or damaged tools returned by customers and which could not be repaired economically. The provision for obsolete inventories relates to certain specific tools and parts which were no longer produced by the Company or listed in its current catalogs, or for which the record showed little or no usage for a period of time. (This does not include other provisions for losses on obsolete and excess stocks of inventories which are included in the unallocated adjustments—see Note (3) (below.)	$ 869,000
b. Adjustments to write off inventories [illegible]ating to three specific unsuccessful [illegible]oducts.	308,000
c. Adjustments to write off (i) tools [illegible]ng used for demonstration purposes by [illegible]esmen and branches, and (ii) vario[illegible] [illegible]ols on trial with customers.	347,000
d. Other adjustments to inventories, including correction of an overstatement ($118,000) in the Italian subsidiary's December 31, 1963, inventory and elimination from inventory valuations of excessive costs ($431,000) and intercompany profits ($79,000).	628,000

	Total Adjustment Allocated to Periods
e. Provisions for returns and allowances and for doubtful accounts in order to state accounts receivable, net of reserves, at the amount of cash estimated to be realizable.	405,000
f. Write-off of the unamortized balance of production tooling costs applicable to discontinued, obsolete and other products where there were significant doubts that the costs could be recovered	364,000
g. Provisions for payments to be made under certain compensation contracts: (i) supplemental payments to retired and former employees under various arrangements ($297,000), and (ii) payments under deferred compensation contracts with former officers ($305,000). No provisions had previously been made in the accounts for the payments described in (i), and payments had been charged to expense as they were made; the adjustments at December 31, 1964, record the liability, actuarially computed, to these retired and former employees. The adjustments at December 31, 1964, with respect to the payments described in (ii) increase the reserve to the amount required at that date.	602,000
h. Other year-end adjustments, including provisions for (i) loss on purchase commitments ($215,000) and (ii) legal expenses ($125,000), and (iii) adjustments of miscellaneous accrued costs and liabilities ($93,000).	433,000
i. 1964 adjustments other than year-end adjustments which affected the restatement of results of operations by periods.	—

	Total Adjustment Allocated to Periods
Total adjustments before income tax credits	$3,956,000
Less—Income tax credits	1,755,000
Total adjustments after income tax credits allocated to specific periods, excluding adjustments for changes in the application of generally accepted accounting principles	$2,201,000

The allocation of the adjustments listed above is summarized by periods in the tabulation below:

	Total Adjustment	Allocated to Year Ended December 31			Allocated to Six Months Ended June 30, 1964 (Memo)
		1964	1963	1962 and Prior	
			(In Thousands)		
(a) Provisions for damaged and obsolete inventories	$ 869	$ 137	$ 271	$ 461	$ 69
(b) Write-off of inventories of three specific products	308	308	—	—	—
(c) Write-off of demonstrator tools and tools on trial.....................	347	71	89	187	16
(d) Other adjustments to inventories.....	628	431	118	79	212
(e) Provisions for returns and allowances and doubtful accounts	405	(35)	104	336	159
(f) Write-off of certain production tooling costs	364	217	(6)	153	(4)
(g) Provisions for certain compensation contracts	602	57	(34)	579	3
(h) Other year-end adjustments.........	433	293	82	58	4
(i) Allocation to prior periods of 1964 adjustments recorded before year-end—					
Physical inventory adjustments disclosed at September 30, 1964...	—	(257)	125	132	500
Correction of certain errors in the recording of sales, inventories and other items primarily as of June 30, 1964	—	(103)	71	32	318
	$3,956	$1,119	$ 820	$2,017	$1,277
Less—Income tax credits	1,755	491	349	915	616
Total	$2,201	$ 628	$ 471	$1,102	$ 661

(2) Adjustments resulting from changes in the application of generally accepted accounting principles included changes in accounting for (a) factory and office supplies, (b) tooling, (c) research and engineering costs, (d) pension costs, (e) employees' vacation pay, (f) investment tax credit, and (g) goodwill, as follows:

a. Factory and office supplies, previously capitalized and charged to income when used, are now charged to expense when purchased.

b. The Company previously followed the policy of capitalizing tooling costs and amortizing these costs over periods ranging from five to ten years. The previously unamortized balance of tooling costs in the accounts at December 31, 1964, is now being written off over a single five-year period 1964-1968. Under the new policy effective January 1, 1965, expenditures for tooling made after 1964 are charged to expense as incurred.

c. The Company previously followed the policy of deferring certain research and engineering costs and amortizing these costs over a four-year period. Under the new policy, these costs are charged to expense as incurred.

d. The Company previously provided each year for the annual normal cost and interest on unfunded past-service costs of the salaried employees' retirement plan; however, no provisions had been made for amortization of the past-service costs. Under the new policy, the Company continues to charge income for the annual normal cost and interest on the unfunded past-service cost; in addition, it is amortizing the unfunded past-service cost over a thirty-year period starting in 1958, the first full year of the retirement plan.

e. The Company previously followed the policy of charging expense for the cost of vacations by salaried and certain hourly employees when the vacations were taken. Under the new policy, the Company accrues on a pro rata basis for the cost of these vacations during the year in which these vacations are earned.

f. During 1962 and 1963 the Company reflected 48% of the investment tax credit in income as a reduction of income tax expense for the year in which the credit arose and deferred the balance as part of the liability for Federal income taxes. During 1964, the Company's accounting policy was changed to amortize the investment credit over the useful lives of the applicable equipment.

g. Under the Company's previous policy, goodwill was being amortized by annual provisions which would have run through 1976, or a period of about twenty years from the date of acquisition of the assets and business of a predecessor company. The Company decided in 1964 to write off the unamortized portion of the goodwill. In effect, this results in a change from the twenty-year amortization period previously used, to a ten-year period.

The effect of the retroactive change in the application of generally accepted accounting principles is summarized as follows:

	Total Adjustment	Allocated to Year Ended December 31: 1964	1963	1962 and Prior	Allocated to Six Months Ended June 30, 1964 (Memo)
		(In Thousands)			
Factory and office supplies	$ 91	$(18)	$ 24	$ 85	$ (8)
Tooling	166	166	—	$ —	83
Research and engineering costs	798	—	117	681	—
Pension costs	484	52	72	360	26
Vacation pay	206	(13)	(11)	230	82
Investment credit	57	30	9	18	(5)
Goodwill	70	8	8	54	4
	$1,872	$225	$219	$1,428	$182
Less—Income tax credits	835	83	99	653	81
Total	$1,037	$142	$120	$ 775	$101

(3) Adjustments not allocated to periods consist primarily of write-downs for obsolete and excess inventories and have been reflected in the accompanying financial statements as a special charge in 1964 because inadequate information is available to support allocation to periods.

* * *

Exhibit E

Notes to Statements of Consolidated Income
and Consolidated Retained Earnings
Years Ended December 31, 1964 and 1963

(1) 1964 Year-End Adjustments and Their Allocation to Accounting Periods:

As a result of the events relating to the rescission of the purchase and sale agreement with Stewart-Warner Corporation, Thor's management conducted extensive investigations and determined that adjustments aggregating $4,727,910 ($8,459,588 before applicable income tax credits) should be made to consolidated income and consolidated retained earnings as of December 31, 1964. The nature of these adjustments, the allocation thereof to periods as a result of a subsequent study and the resulting restatements of consolidated income and retained earnings for the years ended December 31, 1964 and 1963, are summarized in Exhibit A.

* * *

(3) Inventories:

The inventories, priced at the lower of standard cost (first in, first out) or market, used in the computation of cost of sales for 1964 and 1963 were as follows:

December 31, 1964	$ 9,222,000
December 31, 1963	12,704,000
December 31, 1962	11,623,000

* * *

EXHIBIT T

[THOR POWER TOOL COMPANY]

[S. E. C. FORM 10-K]

[For the Fiscal Year Ended December 31, 1965]

* * *

March 25, 1966

OPINION OF INDEPENDENT ACCOUNTANTS*

To the Board of Directors of
Thor Power Tool Company

We have examined the consolidated financial statements of Thor Power Tool Company listed in the accompanying index. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The financial statements at December 31, 1964 were examined by other independent accountants, whose opinion dated April 5, 1965 was subject to the appropriateness of certain changes made during 1964 in accounting principles and practices, particularly as they are related to inventory valuation, which, while considered by them to be reasonable in the circumstances, could only be evaluated in the light of future events.

As explained in Note 2, substantial provisions were made in 1964 and 1965 to reduce certain inventories, considered by management to represent obsolete, damaged and excess stocks, to their estimated realizable value. While the reserves provided reflect the best current judgment of the Company's management, it is not possible to evaluate these reserves prior to the ultimate disposition of the inventories involved.

*** This Opinion is received into evidence to show that the Exhibit contains a statement of the auditors but ". . . it does not prove the truth or the correctness of the matters contained in the statement of the auditor" (A43).**

In our opinion, subject to the effect of the ultimate adjustments arising from the disposition of the inventories referred to above, and subject to the final outcome of the pending litigation described in Note 10, the accompanying consolidated financial statements present fairly the financial position of Thor Power Tool Company and its subsidiaries at December 31, 1965, and the results of their operations for the year, in conformity with generally accepted accounting principles. These principles were applied on a basis consistent with that of the preceding year, the financial statements for which were restated by the Company as described in Note 1.

PRICE WATERHOUSE & CO.

[Caption Omitted]

DECISION

Pursuant to the opinion of the Court filed May 6, 1975, and incorporating herein the facts recited in the respondent's computation as the findings of the Court, it is

ORDERED and DECIDED: That there is a deficiency in income tax due from the petitioner for the taxable year 1963 in the amount of $494,055.99; and

That there is a deficiency in income tax due from the petitioner for the taxable year 1965 in the amount of $59,287.48.

/s/ WILLIAM A. GOFFE
Judge

Entered: Jan 12 1976

It is hereby stipulated that the foregoing decision is in accordance with the opinion of the Court and the respondent's computation, and that the Court may enter this decision without prejudice to the right of either party to contest the correctness of the decision entered herein.

MEADE WHITAKER
Chief Counsel
Internal Revenue Service
By: /s/ CHARLES B. WOLFE, JR.
Charles B. Wolfe, Jr.
Acting Assistant
Regional Counsel
22nd Floor South
219 South Dearborn Street
Chicago, Illinois 60604
Tel. No. (312) 353-3870
Date: Jan 5 1976

/s/ JOHN E. ALLEN
John E. Allen
Counsel for Petitioner
231 South LaSalle Street
Chicago, Illinois 60604
Date: January 5, 1976

[Caption Omitted]

NOTICE OF APPEAL

[Filed April 9, 1976]

Notice is hereby given that Thor Power Tool Company hereby appeals to the United States Court of Appeals for the Seventh Circuit from the decision of this court entered in the above captioned proceeding on the 12th day of January, 1976.

/s/ MARK H. BERENS
Mark H. Berens

/s/ JOHN E. ALLEN
John E. Allen
Room 1955
231 South LaSalle Street
Chicago, Illinois 60604
(312) 782-0600

Of Counsel
MAYER, BROWN & PLATT

Date: April 8, 1976

SUPREME COURT OF THE UNITED STATES

No. 77-920

Thor Power Tool Company,
Petitioner,
vs.
Commissioner of Internal Revenue

ORDER ALLOWING CERTIORARI

FILED MARCH 6, 1978

The petition herein for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit is granted.

No. 77-920

In the Supreme Court of the United States

October Term, 1977

Thor Power Tool Company, petitioner
v.
Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

WADE H. McCREE, JR.,
Solicitor General,
M. CARR FERGUSON,
Assistant Attorney General,
ANN BELANGER DURNEY,
WILLIAM A. WHITLEDGE,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

INDEX

CITATIONS

In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (Pet. App. A-6 to A-32) is reported at 64 T.C. 154. The opinion of the court of appeals (Pet. App. A-34 to A-48) is reported at 563 F. 2d 861.

JURISDICTION

The judgment of the court of appeals was entered on September 29, 1977. The petition for a writ of certiorari was filed on December 27, 1977. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether petitioner failed to meet its burden of proving that its method of valuing its inventory clearly reflected its income for federal income tax purposes.

2. Whether petitioner failed to prove that the Commissioner's rejection of its method of computing its reserve for bad debts was an abuse of discretion.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 166, 446, and 471 of the Internal Revenue Code of 1954 (26 U.S.C.) and Treasury Regulations, Sections 1.166–4, 1.446–1 (a), 1.471–2, and 1.471–4 are set forth at Pet. App. A–1 to A–5.

STATEMENT

1. Petitioner is a manufacturer of tools, parts and accessories. Each of petitioner's sales branches maintains inventories of spare parts and accessories for each tool it manufactures. Petitioner employs the "lower of cost or market" method of valuing its inventory for both financial reporting and federal income tax purposes (Pet. App. A–35 to A–36).

In 1964, petitioner's new management determined that the quantities of raw materials, work-in-process, finished tools and spare parts in inventory was far in excess of what could be sold. After taking an inventory of these items, petitioner wrote off all of its obsolete items of inventory.[1] Petitioner also wrote

[1] The Commissioner permitted that inventory write-off and it is not in issue here.

down the remaining 44,000 items in its inventory to their "net realizable value," as accounting standards required (Pet. App. A–36 to A–37).

Petitioner computed the "net realizable value" of its inventory by estimating the future demand for each item and then writing down the value of each item in inverse proportion to its estimated future demand.[2] Petitioner did not, however, attempt to dispose of any of the items it deemed to be in excessive supply, to segregate the items in its inventory, or to identify any particular item as in excess supply. Petitioner achieved its reduction in its inventory values by means of an inventory reserve account, to which it credited the amounts of the write-downs. Petitioner recorded the corresponding debit as an expense on its financial statements and deducted the amount on its 1964 income tax return (Pet. App. A–36 to A–37).

On audit, the Commissioner of Internal Revenue disallowed petitioner's deductions for inventory devaluation on the ground that they did not clearly reflect its income for federal tax purposes. Petitioner sought

[2] Petitioner reduced its gross usable inventory in the following manner (Pet. App. A–37 n. 6):

"(1) Items not in excess of 12 months' anticipated demand were not written down.

"(2) Items in excess of 12 months' anticipated demand but not in excess of 18 months' anticipated demand were written down 50 percent.

"(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

"(4) Items in excess of 24 months' anticipated demand were written off completely."

review of the Commissioner's determination in the Tax Court. The Tax Court held that petitioner had failed to show the Commissioner had abused his discretion in determining that petitioner's inventory write-downs did not clearly reflect its income. In the Tax Court's view, petitioner's write-down of excess inventory was not permitted by the Treasury Regulations, Section 1.471-1 *et seq.*, which requires that "market" value of an inventry be computed on the basis of "replacement cost" rather than "net realizable value" (Pet. App. A-17 to A-30). The court of appeals affirmed (Pet. App. A-34 to A-47).

2. In 1965, petitioner reviewed each of its outstanding accounts receivable and estimated their collectibility. Petitioner then applied various percentages to the accounts reflecting their estimated degrees of uncollectibility and added the resulting amounts to its bad debt reserve. On its 1965 tax return, petitioner deducted the addition to its bad debt reserve (Pet. App. A-47 to A-48).

The Commissioner rejected petitioner's method of computing its bad debt reserve. He recomputed what he considered to be a reasonable addition to petitioner's reserve on the basis of petitioner's bad debt experience pursuant to the formula in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300 (Pet. App. A-48). The Tax Court held that petitioner failed to sustain its burden of showing that the Commissioner's determination was an abuse of discretion (Pet. App. A-31 to A-32) and the court of appeals affirmed (Pet. App. A-47 to A-48).

ARGUMENT

1. Section 471 of the Internal Revenue Code of 1954 provides that when the inventory method is necessary clearly to reflect a taxpayer's income, the Secretary of the Treasury may prescribe the basis upon which such inventories shall be taken. Section 471 prescribes that the method of computing inventories must meet a two-part test: (1) it must approximate the best accounting practice of the particular business; and (2) it must clearly reflect income. Treasury Regulations Section 1.471-1 *et seq.* permit the use of the lower of cost or market method of valuing inventories and require that any inventory valuation method clearly reflect the taxpayer's income and that a taxpayer's inventory method be consistent from year to year and comply with Treasury Regulations, Sections 1.471-1 through 1.471-11. See Treasury Regulations, Section 1.471-2.[3]

The substance of the Regulations is that a taxpayer employing the lower of cost or market inventory method must compute "market" value as replacement or reproduction cost. If the taxpayer does not compute market value of its inventory in accordance with

[3] Petitioner did not challenge the validity of the Regulations in the courts below. However, it now asserts (Pet. 21-22) that the decision below elevates the Regulations to the status of a statute. It is well established that Regulations not inconsistent with the statute should be sustained if they are reasonable. *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496; *United States* v. *Correll*, 389 U.S. 299. Moreover, since the Regulations here in question were issued pursuant to the express statutory authority of Section 471, they are legislative in character and are given the force and effect of law. *Panama Refining Co.* v. *Ryan*, 293 U.S. 388.

replacement cost, it has the burden to prove that its method clearly reflects its income.

In mid-1964, petitioner changed its inventory method to compute the "market" value of its inventory on the basis of "net realizable value" rather than replacement cost. In the Tax Court, petitioner presented expert testimony which established that its computation of "market" value on the basis of "net realizable value" was in accord with generally accepted accounting principles. However, petitioner presented no evidence that its method clearly reflected its income for federal income tax purposes. Accordingly, the court of appeals (Pet. App. A-45 to A-46) correctly concluded that the Tax Court was not clearly erroneous in finding that petitioner did not prove that its inventory method clearly reflected its 1964 income.

Petitioner renews the argument (Pet. 13-16), rejected by the courts below, that if a taxpayer's method of inventory valuation conforms with generally accepted accounting principles, there is a presumption that the method clearly reflects its income for tax purposes.[4] The contrary is true, however. It is well settled that tax accounting principles differ from generally accepted accounting principles, and that compliance with generally accepted accounting principles does not establish that a taxpayer's method of accounting clearly reflects its income for income tax purposes.

[4] As the court of appeals further noted (Pet. App. A-45), even if there were such a presumption, it was rebutted by petitioner's lack of consistency in computing the "market" value of its opening inventory in 1964 at replacement cost, and its closing inventory at "net realizable value."

See, *e.g., American Automobile Association* v. *United States,* 367 U.S. 687; *Schlude* v. *Commissioner,* 372 U.S. 128.[5]

Moreover, the courts below correctly held that petitioner's method of computing the market value of its inventory was not permitted by the Regulations under Section 471. Section 1.471-2(c) permits the taxpayer to use special valuation procedures for inventory which it proves is "unsalable at normal prices * * * because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes * * *." But as the court of appeals pointed out (Pet. App. A-42), this provision of the Regulation was inapplicable because petitioner failed to prove that its excess inventory was "unsalable at normal prices." Moreover, petitioner did not make an "actual offering" within 30 days of the inventory date to establish a bona fide selling price, as required by Section 1.471-2(c) of the Regulations (see Pet. App. A-42 to A-43 and n. 14).[6]

Finally, contrary to petitioner's contention (Pet. 10), the decision below does not conflict with

[5] Petitioner urges (Pet. 11-12) this Court to "provide guidance concerning the extent to which the Commissioner may exercise his discretion in rejecting generally accepted accounting principles." But the Court has already spoken on the question in *American Automobile Association* v. *United States, supra,* 367 U.S. at 692, and *Schlude* v. *Commissioner, supra.* In those cases, it held that the Commissioner has broad discretion to require that a taxpayer's method of accounting clearly reflects its income despite its use of a generally accepted method of accounting. Moreover, the detailed Regulations under Section 471 are sufficient to define and limit the Commissioner's discretion.

[6] Nor does Section 1.471-4(b) of the Regulations support petitioner's claimed inventory write-down. The evidence showed that

Space Controls, Inc. v. *Commissioner,* 322 F. 2d 144 (C.A. 5), or *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N.D. Ohio), affirmed *per curiam,* 351 F. 2d 449 (C.A. 6). In *Space Controls,* the court held that the taxpayer's write-down of inventory qualified under the specific language of Section 1.471–4(b) of the Regulations (see 322 F. 2d at 151–153). Likewise, in *E. W. Bliss Co.,* the court found that the taxpayer had proved that it had followed its method of inventory valuation for 30 years and that it clearly reflected its income (224 F. Supp. at 385). Here, however, petitioner concedes (Pet. 21), and the courts below concluded (Pet. App. A–41 to A–42), that its write-down of its inventory was not authorized by the Regulations.[7]

2. The court of appeals also correctly held that the Commissioner did not abuse his discretion in rejecting petitioner's method of computing its bad debt reserve. Section 166(a) of the Code permits a taxpayer to claim a deduction for specific debts as they become worthless. Section 166(c) provides that, in lieu of the specific write-off method authorized by Section 166 (a), "there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts." A reasonable addition to a bad debt reserve is the amount necessary to bring the balance in the reserve account to a level that can be reasonably expected to cover the losses anticipated with respect to debts outstanding at the end of the year. *Dixie Furniture Co.* v. *Commissioner,* 390 F. 2d 139 (C.A. 8).

---

it was not unusual for companies engaged in petitioner's business to carry excess inventory. Hence, the valuation procedures applicable where there are "inactive market conditions" (Section 1.471–4(b)) have no pertinence to this case.

[7] *C-O-Two Fire Equipment Co.* v. *Commissioner,* 219 F. 2d 57, 59 (C.A. 3), upon which petitioner relies (Pet. 25–26), is also distinguishable. There, it was undisputed that the taxpayer's inventory became obsolete. The sole question was whether it did so in 1946 or 1947.

At the close of 1965, petitioner estimated the collectibility of each of its accounts. It set aside a 100 percent reserve for accounts it considered to be wholly uncollectible. It also applied the dollar ratio of uncollectible accounts to the total amount of accounts of more than $100 and applied this fraction to 90-day-old accounts with a balance of under $100. Moreover, it established a flat two percent reserve for all other 90-day accounts and all accounts between 30 and 90 days past due. Finally, petitioner established a one percent reserve for all accounts less than 30 days old (Pet. App. A–47). These computations resulted in a total addition to petitioner's bad debt reserve of $135,150 (Pet. App. A–48).

Pursuant to his authority under Section 166(c), the Commissioner recomputed petitioner's bad debt reserve by applying the formula adopted in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula measures the current addition to the bad debt reserve based upon the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A. at 302). The *Black Motor* formula yielded an addition to petitioner's bad debt reserve of $74,790.80 (Pet. App. A–48).

As the court of appeals observed, Section 166(c) gives the Commissioner discretion to determine the reasonableness of any addition by a taxpayer to a bad debt reserve. In order to overturn the Commissioner's determination, the taxpayer must show an abuse of that discretion. *Calavo, Inc.* v. *Commissioner,* 304 F. 2d 650, 653–655 (C.A. 9); *Consolidated-Hammer Dry Plate & Film Co.* v. *Commissioner,* 317 F. 2d 829, 834 (C.A. 7); *Akron National Bank & Trust Co.* v. *United States,* 510 F. 2d 1157 (C.A. 6); *Merchants Industrial Bank* v. *Commissioner,* 475 F. 2d 1063 (C.A. 10); *Paramount Finance Co.* v. *United States,* 304 F. 2d 460 (Ct. Cl.). Petitioner has not done so.

Contrary to petitioner's argument (Pet. 29–30), the decision below does not conflict with *Rhode Island Hospital Trust Co.* v. *Commissioner,* 29 F. 2d 339 (C.A. 1), *Calavo, Inc.* v. *Commissioner, supra,* or *Travis* v. *Commissioner,* 406 F. 2d 987 (C.A. 6). In each of those cases, the courts reaffirmed the Commissioner's statutory discretion with respect to bad debt reserves. However, the taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve was an abuse of discretion. Here, on the other hand, petitioner failed to make that showing. The court of appeals correctly concluded that "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (Pet. App. A–48).

CONCLUSION

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.,
Solicitor General.

M. CARR FERGUSON,
Assistant Attorney General.

ANN BELANGER DURNEY,
WILLIAM A. WHITLEDGE,
Attorneys.

FEBRUARY 1978.

U.S. GOVERNMENT PRINTING OFFICE: 1978

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITIONER'S REPLY TO BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner,
Thor Power Tool Co.

Of Counsel:
MAYER, BROWN & PLATT.

Gunthorp-Warren Printing Company, Chicago • Financial 6-6568

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977.

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

PETITIONER'S REPLY TO BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR CERTIORARI

INVENTORY ISSUE

I.

Respondent's brief wholly ignores that there are 371 cases docketed in the Tax Court and an unknown number pending in Federal District Courts involving the valuation of excess inventory. There are an additional 493 cases pending in the Appellate Division and an estimated several times that number in the Audit Division of the Internal Revenue Service, a substantial number of which inevitably will find their way into the courts. See *amicus* brief of the National Association of Manufacturers ("NAM") 4. This case thus presents an unusual opportunity for this Court to resolve the excess inventory valua-

tion issue by a definitive decision, thereby avoiding years of wasteful litigation and relieving the Federal courts of most of the pending cases.

A review by this Court would be particularly effective in reducing litigation in this instance because both the Commissioner and the Tax Court are interpreting the decision of the Seventh Circuit as an absolute prohibition against the writedown of excess inventory prior to its scrapping. See Rev. Rul. 77-364, I. R. B. 1977-41, p. 9 (discussed in the NAM brief 8), and *Altec Corporation*, 36 T.C.M. 1795 (CCH) (Tax Court Memorandum Decision 1977-438, December 29, 1977).

This case involves more than a technical tax issue with an extraordinarily large amount of potential tax liability to thousands of businesses. As the thoughtful *amicus* briefs filed in this case by the NAM and the Chamber of Commerce of the United States ("Chamber") abundantly show, the decision of the Seventh Circuit flies in the face of deeply rooted concepts of the business and accounting communities as to what constitutes taxable income. To require unsalable inventory to be valued far above its actual realizable value, and thereby increase taxable income by such overvaluation, strikes the businessman as profoundly unrealistic and unfair.[1]

II.

Respondent's brief fails to come to grips with the central question involved in this case—does the action of the Commissioner in refusing to allow excess inventory to be written down to net realizable value conform to the dual statutory mandate of section 471 that a taxpayer's inventory method must (i) constitute the best accounting practice in the taxpayer's trade or business and (ii) clearly reflect income. Neither the Seventh Circuit nor Respondent questions the Tax Court's findings that

1. The S. E. C. would view it as illegal to overstate income in such a way.

Thor's inventory valuation procedures constituted the best accounting practice and that these procedures, required by generally accepted accounting principles, clearly reflected Thor's income for *financial accounting purposes.*

Notwithstanding these facts, Respondent argues, parallel to the opinion of the Seventh Circuit, that Thor has not proven that its income was clearly reflected for *income tax purposes.* The only authoritative source available to Thor for establishing this are the Regulations and generally accepted accounting principles.

It is conceded by both sides that the Regulations do not explicitly cover the valuation of excess stock. Although provisions of the Regulations defining market value, § 1.471-4(b), and permitting the writedown of subnormal goods, § 1.471-2(c), could be construed to authorize Thor's valuation procedures (see Petition 21-24 and Chamber brief 14-17), Respondent argues that the Seventh Circuit was correct in narrowly and literally construing them not to do so. Respondent's position seems to be founded on the premise that unless the Regulations explicitly permit a taxpayer to write down excess inventory to net realizable value, he is prohibited from doing so (*e.g.*, Resp. brief 5, 7). Respondent even suggests that these Regulations are "legislative in character" (*id.*, 5, n. 3). While it is highly questionable whether the inventory Regulations fall within the purview of legislative regulations, it is inconceivable that the failure of regulations to deal explicitly with an issue could be deemed legislative.[2]

Thor's attempt to show that it clearly reflected its income based on the authority of generally accepted accounting principles is rejected by Respondent for the reason that "[i]t is well settled that tax accounting principles differ from generally accepted accounting principles, and that compliance with gen-

2. Respondent does not seem troubled by the Treasury's long-continued failure to amend the Regulations to cover the valuation of excess inventory, notwithstanding its knowledge that they were inadequate. See Petition 23 and Chamber brief 6-7.

erally accepted accounting principles does not establish that a taxpayer's method of accounting clearly reflects its income for income tax purposes" (Resp. brief 6), citing this Court's prepaid service income decisions in *American Automobile Association* v. *United States,* 367 U. S. 687 (1961), and *Schlude* v. *Comm'r,* 372 U. S. 128 (1963). This approach erroneously upgrades a narrow exception to the status of the general rule. Both cases involved the limited issue of whether prepaid service income of an accrual basis taxpayer was taxable in the year received or could be amortized over the years the services were to be rendered. In two 5-4 decisions, this Court held that prepaid income was taxable when received, primarily because a unique legislative history showed that to be the intent of Congress. 367 U. S. at 694-98; 372 U. S. at 134-35. Nothing in either majority opinion suggests in the slightest that this Court was adopting a general policy that tax accounting was no longer to follow generally accepted accounting principles as its progenitive authority. To the contrary, some 15 years after those decisions, they remain the only significant non-statutory exception to the rule that tax accounting follows generally accepted accounting principles. See generally 367 U. S. at 698-703 and 372 U. S. at 137 (dissents by Stewart, J.).

Moreover, there is no reference in either decision to inventory valuation or section 471. Indeed, if the express language of section 471—requiring inventory to be valued according to the best accounting practice—is to be followed, the prepaid income cases cannot govern the valuation of inventory.

Respondent's brief also disputes the inherent conflict in principle between the decision of the Seventh Circuit in the instant case and those of the Fifth and Sixth Circuits in *Space Controls Inc.* v. *Comm'r,* 322 F. 2d 144 (5th Cir. 1963), and *E. W. Bliss Co.* v. *United States,* 351 F. 2d 449 (6th Cir. 1965), *affirming on the opinion below,* 224 F. Supp. 374 (N. D. Ohio 1963). In those cases, the Courts of Appeals complied with the statutory mandate of section 471 and construed the Regulations to con-

form to generally accepted accounting principles. See 322 F. 2d at 148-49, 154-55; 224 F. Supp. at 379-82. As a consequence each court permitted the taxpayer to write down inventory to net realizable value, notwithstanding the Commissioner's arguments, *identical to those made in this case,* that the Regulations required valuation at replacement cost and that no writedown could take place without a "realization"—*e.g.,* by delivery to the customer (scrapping in the instant case). The decision below conflicts with these decisions because the Seventh Circuit concluded that generally accepted accounting principles were irrelevant in determining whether or not Thor's writedown of excess inventory to net realizable value clearly reflected its income.

Perhaps the most vexing aspect of Respondent's brief is that it ignores the common sense of the issue before this Court. Notwithstanding that the Regulations do not adequately provide for the valuation of excess inventory, of which the Treasury has been aware for years, Respondent in effect argues that such silence constitutes a *de facto* prohibition against writing down such inventory to net realizable value. The realistic alternative of construing the Regulations by reference to the more advanced and comprehensive concepts of generally accepted accounting principles is rejected solely on the basis of the *non sequitur* that tax accounting does not follow generally accepted accounting principles in the limited area of prepaid service income. Like the opinions of both courts below, Respondent's brief does not explain how Thor's valuation procedures failed to clearly state its income. Thus, under Respondent's approach Thor is unable to prove that its valuation procedures clearly reflect income by reference either to the Regulations or to generally accepted accounting principles. Thor consequently is deprived of the benefit of the specific language of section 471[3] and § 1.471-2(b)

3. The limited legislative history of section 471 supports its clear language. See Chamber brief 8 and NAM brief 9.

of the Regulations thereunder, which create the presumption[4] that inventory values determined in accordance with the best accounting practice clearly reflects taxable income. The result is that Thor's inventory for 1964 is overvalued by some $927,000, thereby overstating its taxable income for that year by the same amount. This overstatement continues indefinitely until the excess inventory is scrapped in later years.

BAD DEBT ISSUE

Although Respondent repeatedly refers to the incomplete and ambiguous Regulations as authority in discussing the inventory issue, Respondent fails to mention that the automatic imposition of the *Black Motor* formula is directly contrary to the language of § 1.166-4(b)(1) of the Regulations, which require that taxpayers' reserve for bad debts ". . . shall be determined in light of the facts existing at the close of the taxable year . . .".

Respondent couples this omission with the remarkable assertion that the decision of the Seventh Circuit does not conflict with *Calavo Inc.* v. *Comm'r*, 304 F. 2d 650 (9th Cir. 1962); *Rhode Island Hospital Trust Co.* v. *Comm'r*, 29 F. 2d 339 (1st Cir. 1928); or *Travis* v. *Comm'r*, 406 F. 2d 987 (6th Cir. 1969), because in those cases the "taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve was an abuse of discretion" (Resp. brief 10), which Respondent erroneously contends Thor failed to do in the instant case. To the contrary, in each of those decisions, the Commissioner was found to have abused his discretion because he refused to consider current data as to the collectibility of the taxpayers' accounts receivable. In contrast with those decisions, the Seventh Circuit extends to the Com-

4. Respondent (brief 6 n. 4) refers to the Seventh Circuit's statement that the presumption was rebutted by Thor's alleged lack of consistency in computing its opening and closing inventories for 1964. As already explained in the Petition (p. 25 n. 7) the point is without merit because by pretrial order the Tax Court excluded any evidence on this point.

missioner a *carte blanche* right to impose the *Black Motor* historical formula regardless of the reasonableness of the taxpayer's current data on the collectibility of its accounts. To Thor's knowledge, no other court has gone that far.

CONCLUSION

Respondent's brief continues the Seventh Circuit's inconsistent position between the inventory and bad debt issues. As discussed more fully in the Petition (p. 12), Respondent objects to Thor's use of a formula to identify and value excess quantities of some 44,000 different items of inventory that it could not feasibly individually value, while Respondent simultaneously insists that Thor use an historical formula to value its accounts receivable that it had individually valued.

* * *

For these reasons and those stated in the Petition, Petitioner respectfully requests that the Writ of Certiorari be granted.

Respectfully submitted,

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner,
Thor Power Tool Co.

Of Counsel:
MAYER, BROWN & PLATT.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR PETITIONER

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner, Thor Power Tool Co.,

Of Counsel:
MAYER, BROWN & PLATT.

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

INDEX

PAGE

CITATIONS

Cases

Statutes

Treasury Regulations

I.R.S. Rulings

S.E.C. Materials

Miscellaneous

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinions of the United States Tax Court, 64 T. C. 154 (1975), and of the United States Court of Appeals for the Seventh Circuit, 563 F. 2d 861 (1977), are respectively reproduced in the Appendix to the Petition at A-6 and A-34.

JURISDICTION

The judgment of the Court of Appeals was entered on September 29, 1977 (Pet. A-33). A Petition for Certiorari was filed in this Court on December 27, 1977, asserting jurisdiction pursuant to 28 U. S. C. § 1254(1). This Court granted the Petition on March 6, 1978 (A267).

STATUTE AND REGULATIONS INVOLVED

The relevant sections of the Internal Revenue Code for the period in question (which remain substantively unchanged) are:

Section 446, 26 U. S. C. § 446, providing in part:

"General Rule for Methods of Accounting.

"(a) GENERAL RULE.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) EXCEPTIONS.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

"* * *"

Section 471, 26 U. S. C. § 471:

"General Rule for Inventories.

"Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Section 166, 26 U. S. C. § 166, providing in part:

"Bad Debts.

"(a) General Rule.—

(1) Wholly worthless debts.—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts.—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

"* * *

"(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

"* * *"

Treasury Regulations §§ 1.446-1(a), 1.471-2, 1.471-4, and 1.166-4, in effect for the years at issue, are set out in the Appendix to the Petition (Pet. A-1 through A-5).

QUESTIONS PRESENTED

1. Did the Court of Appeals err in holding that the Commissioner did not abuse his discretion by disallowing Thor's writedown of "excess goods"—primarily replacement parts held in quantities exceeding the number which Thor reasonably determined would be sold, and which eventually would be scrapped—from cost to net realizable value (*i.e.*, scrap value), where such writedown:

(a) is, consistent with § 446 of the Code, in accordance with generally accepted accounting principles;

(b) fulfills the requirement of "best accounting practice" in Thor's trade or business within the meaning of § 471 of the Code;

(c) clearly reflected Thor's income for financial accounting purposes; and

(d) is not inconsistent with the applicable Treasury Regulations, but in fact is authorized by a construction of them that effectuates the intention of § 446 and § 471?

2. Did the Court of Appeals err in holding that the Commissioner did not abuse his discretion by requiring that Thor's 1965 addition to its reserve for bad debts be calculated solely by a mechanical 6-year average of Thor's past bad debt charge-offs, which, contrary to the Treasury Regulations, ignored current facts and circumstances affecting the collectibility of Thor's accounts receivable at the close of that taxable year?

STATEMENT OF THE CASE

The relevant facts are uncontroverted and are well-summarized in the Tax Court's Findings of Fact (Pet. A-8 through A-17).

Inventory Issue

In determining Thor's taxable income for 1964, the Commissioner disallowed $926,952 of Thor's "cost-of-goods-sold," which was the amount by which Thor had written down its closing inventory for excess and unsalable goods.

The "Explanation of Adjustments" in the Statutory Notice of Deficiency states (A3):

> "The deduction of $22,279,949.71 claimed for cost of goods sold is disallowed to the extent of $1,079,069.00 representing writedown of inventory due to anticipated losses because it has not been established that such amount constitutes an allowable deduction under section 162 or any other section of the Internal Revenue Code of 1954."*

During 1964 and for all pertinent years before and after that year, Thor valued its inventory by the method of accounting known as the "lower-of-cost-or-market," applied on a first-in, first-out (FIFO) sequence (Pet. A-9).

Thor manufactures and sells hand-held power tools, parts and accessories for commercial and household uses and commercial rubber products. A typical Thor tool contains from 50 to 200 individual parts, each of which Thor stocks to meet expected customer demand for replacement parts. Because it is

* Both the $1,079,069 and the reference to § 162 were in error. The parties agree and the Tax Court found that the correct amount at issue is $926,952 (Pet. A-13).

The Tax Court held that cost-of-goods-sold is not a deduction subject to the rules of § 162 or any other section of the Code, but is a constitutionally required reduction from gross receipts to determine gross income (Pet. A-17).

practically impossible to accurately predict future demand for individual parts at the time they are manufactured, Thor produces liberal quantities of each part to avoid additional production runs to replenish the supply of a part that has been exhausted. Such reruns require uneconomical tooling and set-up costs that substantially increase the cost of the part and cause delays in supplying it to customers (A55).

Thor attempts to maintain a complete inventory of replacement parts for each tool model so long as a significant population of that model remains in use, which may be for many years after Thor has discontinued producing it. Thor does not scrap its supply of a particular part until it is reasonably sure that there will be little or no future customer demand for that part (A54).

The maintenance of ample inventories of parts and accessories is vital to serving the needs of Thor's customers. In 1965, over 30% of Thor's total sales were of parts and accessories (A54).

In 1960, Thor initiated a procedure for reducing the inventory value of replacement parts and accessories for tool models it no longer produced by amortizing their cost over the 10-year period following the discontinuance of the model's production.* For the years 1960 through 1963 such writedowns, totalling $152,117, were not questioned by the Commissioner on audit. During 1964 this procedure resulted in an additional $22,090 writedown (Pet. A-9).

In late 1964, Thor's new management, which had just been installed by agreement with Thor's principal shareholder,** concluded that Thor's inventory was greatly overvalued, causing it

* The reduction in inventory value was effected through an inventory contra account entitled "Reserve for Inventory Valuation" to which the writedowns were credited. This credit reduced closing inventory for the year, thereby increasing cost-of-goods-sold and reducing income for that year by an equal amount (Pet. A-9–A-10).

** For background, see the Tax Court's Findings (Pet. A-10).

to undertake a careful and detailed analysis of closing inventory incident to closing the books and preparing the financial statements as of December 31, 1964. This resulted in writeoffs and writedowns totalling $3,000,000, including $1,603,000 for obsolete inventory, and $245,000 for three products held in quantities estimated to be in excess of what could be sold (A52–A56).

There remained some 44,000 different items in inventory at Thor's factories and branches, many of which were held in quantities substantially in excess of any reasonably foreseeable demand, as follows:

	Number of Different Items
Raw Materials	4,297
Work-in-Process	1,781
Finished Parts & Accessories	33,670
Finished Products	4,344
Total Number of Inventory Items	44,092

Because of the great number of these items and the relatively low value of each of them, it was impractical within realistic cost or time limits, to estimate on an item-by-item basis how many units of each item would be sold or used in manufacturing finished goods. Instead, based on long manufacturing experience and a careful review of the situation, management utilized two procedures to ascertain the extent by which inventory exceeded anticipated customer demand and to accurately value that excess (Pet. A-10–A-11).

Under the primary procedure, expected demand for each item was forecast on the basis of actual 1964 usage—actual sales for tools, service parts and accessories, and actual production for raw materials, work-in-process and production parts. Using this data, the value of the inventory was reduced as follows:

(i) that quantity of each item not in excess of 12 months anticipated demand was not written down;

(ii) that quantity of each item in excess of 12 months, but not in excess of 18 months anticipated demand, was written down 50% ;

(iii) that quantity of each item in excess of 18 months, but not in excess of 24 months anticipated demand, was written down 75% ; and

(iv) that quantity of each item in excess of 24 months anticipated demand was written off.

The mechanics of this procedure are well-illustrated by the following example from the Tax Court's Findings of Fact (Pet. A-11–A-12). It assumes that 100 units each of five different items were on hand at December 31, 1964, and that their 1964 usage ranged from 20 to 100 units.

Item	Units on Hand at 12/31/64	Units Sold or Used in 1964	Anticipated Demand 0-12 Months	13-18 Months	19-24 Months	+24 Months	% of Write-down
A	100	20	20	10	10	60	
			0%	50%	75%	100%	
			0	5	7.5	60	= 72.5%
B	100	40	40	20	20	20	
			0%	50%	75%	100%	
			0	10	15	20	= 45.0%
C	100	60	60	30	10	0	
			0%	50%	75%	100%	
			0	15	7.5	0	= 22.5%
D	100	80	80	20	0	0	
			0%	50%	75%	100%	
			0	10	0	0	= 10.0%
E	100	100	100	0	0	0	
			0%	50%	75%	100%	
			0	0	0	0	= 0.0%

Application of Thor's item-by-item procedure to each of the five items results in writedowns from 72.5% for item A to none for item E, even though there were 100 units of each item in closing inventory. By this procedure Thor did *not* simply eliminate a fixed percentage of its inventory. Instead, as the example

shows, *actual usage* during 1964 for each of the 44,000 individual items was utilized on an item-by-item basis to estimate how many units of that item eventually would be sold or used in production. That quantity *of each item* determined to be salable or usable was carried at cost (or if lower, at current replacement cost), and the quantity deemed excess and unsalable was written down to its net realizable value (*i.e.*, scrap value).

The procedure is self-correcting in that any increase in sales of a particular item from one year to the next automatically decreases the amount of that item treated as excess at the end of the second year; conversely any decrease in sales increases the writedown for excess inventory in the latter year.*

A supplementary procedure was used (in addition to the primary procedure) at two plants where the 1964 usage data was insufficient to fully forecast future usage. This procedure consisted of percentage writedowns for 9 categories of items (Pet. A-12; Ex. 13, A38, A209):

Percentage Writedown	Number of Categories	Description	Amount of Writedown
5%	2	Tool parts and motor parts at LaGrange Park tool plant	$ 26,341
10%	6	Raw materials, manuals and name plates, and work-in-process at LaGrange Park plant; raw materials, work-in-process and finished goods at Cincinnati rubber plant	99,954
50%	1	Hardware items at LaGrange Park plant	34,537
			$160,832

* To illustrate, assume that the sales of Item A increased from 20 units in 1964 to 40 in 1965. At the end of 1965 there would be 60 units (100 minus 40) actually in inventory. Based on the 40 sold during 1965, the 60 units represent 18 months' demand —40 units for the first 12 months and 20 units for the next 6 months. Under the procedure, 50% of the 20 units, or 10 of them, would be written down, leaving a balance of 50 units. The writedown in the previous year totalled 72.5 units, leaving a balance of 27.5. This requires the *value* of 22.5 units to be *restored* to inventory at the end of 1965 to reach the required balance of 50 units. This restoration increases closing inventory, reduces the cost-of-goods-sold, and increases taxable income by the same amount.

The same correction works in reverse where the demand for the succeeding year has been overestimated.

The 50% writedown was required because numerous hardware items were stored without identifying part numbers, making it impractical to use much of this hardware (A140).

Thor's total writedown for excess inventory for 1964 was:

10-year amortization of parts for discontinued tools	$ 22,090
Primary writedown procedure	744,030
Supplementary writedowns	160,832
	$926,952

The entire writedown was disallowed by the Commissioner.

Of the total writedown of $927,000, $847,000 appertained to Thor's Tool Division; of this amount, 78% was specifically identified as having been scrapped from 1965 through 1971 (Ex. 17, A38, A218).*

Thor did not attempt to sell the excess finished parts and accessories, which for the years 1964 through 1971 represented from 70% to 82% of the excess inventory writedown, at reduced prices, because the market for them is confined to owners of the related tools who purchase replacement parts when and if needed, and will not buy unneeded parts merely because of price reductions. It tried to sell excess quantities of work-in-process (consisting of partially completed parts and tools) and of raw materials, but learned that these were salable only as scrap. Some excess finished tools were sold at reduced prices, but most were so highly specialized that price reductions did not stimulate additional sales (Pet. A-14).

Mr. Arthur R. Collins, who became President of Thor in late 1964, testified that he personally directed the inventory valuation procedures Thor used in preparing its 1964 financial

* Actual scrappings were significantly higher than the amounts reported. Thor's sales branches did not record their scrapping (Pet. A-14—A-15), and the accounting experts testified that a sizable portion of goods actually scrapped by a manufacturer such as Thor are not recorded as such, but show up as unidentified inventory shortages (A111—A112, A138, A161, and A179).

statements, and that the principal judgments underlying the excess inventory writedowns were based on his then more than 20 years' experience in the manufacturing industry (A51, A53–A58). He explained that the primary writedown formula actually adopted was a pragmatic compromise between writing off all inventory in excess of one year's supply, which probably would have been too large a writeoff in Thor's situation, and writing off only inventory in excess of two years' supply, which would have been insufficient because of potential technological and market changes (A57–A58). Mr. Collins testified that the percentages used in the supplementary procedure were selected for each category on the basis of judgment, explaining that "[a]dmittedly, this is not a precise way of doing it, but we felt some adjustment of this nature was in order, and these figures represented our best estimate of what was required to reduce the inventory to net realizable value" (A67). He pointed out that in 1971, these supplementary procedures were used to *decrease* the writedown under the primary procedure by $97,373, thereby increasing taxable income that year by the same amount (A64–65; Ex. 27, Tr. 121, A227). He further testified without contradiction that the sole purpose of all the inventory procedures was to reach an accurate inventory valuation at the end of 1964, and that income tax consequences were not considered at all (A61).

In 1970, Thor engaged Arthur Andersen & Co. as its independent auditors. Wilson J. Besant, C. P. A., the partner-in-charge of Arthur Andersen's initial audit, testified that his firm performed special "first-time-through" procedures, including a detailed review of Thor's excess inventory valuation procedures. This special review confirmed that Thor's procedures were in accord with generally accepted accounting principles and were reasonable (A84–A89). Based on his review of the data from 1962 through 1971, including the declining trends of Thor's sales, domestic profits and gross profit percentage, and the extent of the inventory scrapping, Mr. Besant testified that Thor's writedown of excess inventory in 1964 was "not exces-

sive", and in fact may have been insufficient (Ex. 19, A88, A219; A90–A92).

This testimony of Thor's chief executive officer and of its independent certified public accountants was corroborated without contradiction by five expert witnesses, all of whom were leaders in the public accounting profession.* Each of them testified that at the end of 1964 Thor had excess inventory which it was obligated to write down in order to comply with generally accepted accounting principles (A53–A54, A108,

* The preeminent practicing accountants who testified on behalf of Thor were:

The late Robert M. Trueblood, C. P. A. since 1937, and at the time of trial Chairman of the Board of Touche Ross & Co.; past president of the American Institute of Certified Public Accountants ("AICPA"); then Chairman of the AICPA 9-member Commission on the Objectives of Accounting; former member of the AICPA Long-Range Objectives Committee and Accounting Principles Board, which for many years was the accounting profession's primary authority on matters of accounting principles and practice (A96–A97).

Newman T. Halvorson, C. P. A. since 1930, and at the time of trial the national partner-in-charge of Technical Auditing and Accounting Services for Ernst & Ernst; member of the Accounting Principles Board (A152–A154).

Bertrand J. Belda, C. P. A. since 1931, and at the time of trial the national partner-in-charge of Management Consulting Services for Ernst & Ernst, specializing in management accounting, including matters of inventory valuation. He participated in drafting the comments which the Division of Federal Taxation of the AICPA submitted in 1972 to the Internal Revenue Service, at its request, on the proposed revisions of the Regulations governing the valuation of inventories (Ex. 29, A151, A223), referred to at p. 64 *infra* (A126–A127, A147–A151).

Frank T. Weston, C. P. A. since 1939, at the time of trial Chairman of the Committee of Accounting and Auditing Standards of Arthur Young & Co.; member of the Accounting Principles Board and of the 9-member Commission on the Objectives of Accounting (A186–A188).

Howard B. Burris, C. P. A. since 1950, and at the time of trial a partner of S. D. Leidesdorf & Co., member of the Committees on Auditing Procedure and on Accounting Principles of that firm; member of the AICPA Committee on Auditing Procedure (A172–A173).

A137, A158, A176, A195). After reviewing the facts in this case—including the causes of the writedown for excess inventory, the nature of Thor's business, its history of declining sales and declining gross and net profit margins, and the extent of its scrap dispositions—each expert witness concluded that *both procedures* actually employed by Thor were in accord with generally accepted accounting principles, and would have been approved by his accounting firm (*primary writedown procedure:* A109–A113, A133–A139, A159–A161, A176–A180, A195–A196; *supplementary procedure:* A113, A139–A140, A162, A180–A181, A196–A198). Each testified that if his firm had been Thor's independent auditors at the end of 1964, he would have insisted that Thor write down any excess inventory to net realizable value, and if Thor had refused to do so, his firm would have been unable to give an unqualified opinion certifying Thor's financial statements (income statement and balance sheet) for that year (A114, A133, A158, A176, A195).

Consistent with this testimony, the Tax Court found as facts that (Pet. A-15):

> "Petitioner's closing inventory at December 31, 1964, contained items which, in the opinion of petitioner's management, were unsalable in the normal course of business because they were in excess of reasonably foreseeable demand. *Generally accepted accounting principles required that petitioner reduce the value of its inventory to its net realizable value by eliminating the cost of such excess items.* If petitioner had failed to reflect such a reduction on a reasonable basis, an independent certified public accounting firm auditing its books would have been unable to issue an unqualified opinion certifying that petitioner's financial statements had been prepared in accordance with generally accepted accounting principles. The procedures utilized by petitioner's management to reduce the value of its 1964 closing inventory, *and in particular the procedures it used for eliminating the cost of excess stock,* were consistent with the generally accepted accounting principle of stating inventories at the lower of cost or market, and resulted in petitioner's stating the inventory in

issue at its estimate of current net realizable value." (Emphasis added.)

In its opinion, the Court stated (Pet. A-19–A-20):

"Petitioner produced distinguished members of the accounting profession who testified that the inventory valuation methods employed by petitioner were in accordance with generally accepted accounting principles and thoroughly convinced us that such was the case. A write-down of inventory for excessive stock in this case was not merely desirable for accounting purposes, it was *required* in order to produce a certified balance sheet. Petitioner has, therefore, amply demonstrated that *the write-down of inventory was in accordance with generally accepted accounting principles and within the term, 'best accounting practice,'* as that term is used in section 471 of the Code and the regulations promulgated under that section." (Emphasis added.)

Notwithstanding its factual findings, the Tax Court held that the Commissioner had not abused his discretion in determining that Thor's inventory writedown procedures did not clearly reflect its income. The Court's conclusion seems to rest on three propositions:

(i) that even though a taxpayer's inventory valuation procedures conform to generally accepted accounting principles and constitute the best accounting practice in the taxpayer's trade or business, the Commissioner has discretion to determine that such procedures do not clearly reflect the taxpayer's income, which determination will be upheld unless it is "plainly arbitrary" (Pet. A-20–A-21);

(ii) that, as a matter of law, a taxpayer's inventory procedures clearly reflect income only if those procedures satisfy the requirements of the "more specific" sections of the Regulations (Pet. A-23); and

(iii) that Thor's procedures for valuing excess inventory "based upon an otherwise unsupported opinion of the taxpayer as to its ultimate salability . . . would, within some unknown limits, permit the taxpayer to determine

how much tax it wanted to pay for a given year" (Pet. A-26).

The trial judge's opinion was not reviewed by the full Tax Court.

The Court of Appeals affirmed for reasons similar in substance to those adopted by the Tax Court (Pet. A-41–A-46). It concluded that the Commissioner did not abuse his discretion in requiring that Thor physically scrap the excess inventory as a prerequisite to writing it down to net realizable value (Pet. A-46–A-47).

Bad Debt Issue

In 1965, the Commissioner disallowed $74,791 of Thor's addition to its reserve for bad debts, stating in the "Explanation of Adjustments" in the Statutory Notice of Deficiency (A3):

"The deduction of $136,150.36 for bad debts under reserve method is disallowed to the extent of $74,790.80 because it has not been established that any amount in excess of $61,359.56 constitutes a reasonable addition to the reserve under section 166 of the Internal Revenue Code of 1954."

Thor has calculated its bad debt expense by the reserve method, authorized by § 166(c) of the Code, for 1965 and all pertinent years before and after that year.

The Tax Court found that at the end of 1965, each of Thor's accounts receivable from unrelated persons in excess of $100 was individually reviewed by the credit clerk familiar with that account. If an account was judged to be wholly uncollectible, a 100% reserve was established for it. Several accounts totalling $183,986 were determined to be uncollectible. Other accounts were reserved against by 1% if they were not overdue by more than 29 days, and by 2% if they were overdue longer than that. Accounts of less than $100 were reserved against in the same ratio as those above $100. The determinations of the credit clerks were independently reviewed by Thor's credit manager,

then by its treasurer, and finally by its president (Pet. A-16, A-17).

These procedures established that a reserve of $228,946 was needed (Ex. 18, A38, A222):

	Percentage Applied	Amount of Reserve Needed	Percent of Total Reserve
Wholly Uncollectible	100%	$183,988	80.4%
Overdue more than 29 days	2	24,812	10.8
Not overdue by more than 29 days	1	19,403	8.5
Miscellaneous Adjustments	—	746	.3
Total		$228,948	100.0%

This required a $136,150 addition to the existing $92,798 balance of the reserve.

Notwithstanding these exacting procedures, the Commissioner determined that a reasonable addition to the reserve was limited by a 6-year average of Thor's past bad debt writeoffs, based on a formula first used in *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other issues*, 125 F. 2d 977 (6th Cir. 1942), *acq.* 1944 C. B. 3. This historical average did not give any effect to Thor's judgment that at the end of 1965 some $184,000 of its receivables was wholly uncollectible, which constituted 80.4% of the total reserve Thor determined was necessary at the end of that year.

The Commissioner introduced no evidence at trial on this issue nor explained why or how Thor's bad debt evaluation was improper or inaccurate. He has not questioned the accuracy of Thor's determination that $184,000 of its receivables were uncollectible.

Four expert accounting witnesses testified that from the viewpoint of generally accepted accounting principles, the *Black*

Motor formula is deficient because it ignores present and future factors affecting the collectibility of accounts receivable (A120-A122, A144-A146, A167, A185-A186).

Notwithstanding its Findings (Pet. A-16–A-17), which recognized the detailed procedures Thor had utilized in calculating the 1965 addition to its reserve, the Tax Court held that the Commissioner had not abused his statutory discretion by limiting the reserve to the 6-year average of Thor's bad debt chargeoffs. The Court did not mention the uncollectible accounts, but simply concluded (Pet. A-32):

> "The burden on petitioner was to show that the Commissioner's determination was arbitrary, not that petitioner's method was better."

The Court of Appeals did not question the Tax Court's Findings. It held, seemingly as a matter of law, that the *Black Motor* formula was "reasonable" so that its use by the Commissioner did not constitute an abuse of his discretion, stating (Pet. A-48):

> ". . . In order to overturn the Commissioner's disallowance, therefore, the taxpayer must show that the Commissioner has abused his discretion. *Calavo, Inc.* v. *Commissioner*, 304 F.2d 650, 653-654 (9th Cir. 1962). This is a 'heavy burden.' . . . As we have stated before, the issue thus presented 'is whether the Commissioner's view is reasonable.' . . . If it is, the inquiry is ended. We agree with the Tax Court that the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable."

SUMMARY OF ARGUMENT

Inventory Issue

Section 446 of the Code sets forth in mandatory language the general rule that taxable income shall be computed according to the method of accounting by which the taxpayer keeps his books unless it "does not clearly reflect income". This requirement originated with the Revenue Act of 1918. Continuously since the issuance of Treasury Regulations 45 interpreting the 1918 Act, the Regulations have provided that if a taxpayer's method of accounting conforms to "approved standard methods of accounting" or to "generally accepted accounting principles," it "will ordinarily be regarded as clearly reflecting income". See Treas. Reg. § 1.446-1(a)(2). Almost identical language was used in the discussion of § 446 in the Reports of the House and the Senate accompanying the 1954 Code, H. R. Rep. No. 1337, 83d Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954).

Section 471 of the Code more particularly requires that inventory accounting shall conform "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income". This statutory language also emanates from the 1918 Act. Commencing with Regulations 45 interpreting that Act until 1973, the Regulations provided that an inventory that can be used under "the best accounting practice" in the taxpayer's trade or business "can, as a general rule, be regarded as clearly reflecting his income". Treas. Reg. § 1.471-2(b).

Whether the language of the Regulations under both § 446 and § 471 is deemed to set forth general rules or to create rebuttable presumptions, the effect is the same. It has been in both Regulations for more than a half-century through 12 reissuances of the Regulations, during which the relevant sections

of the statute were reenacted in seven Revenue Acts and in the codifications of 1939 and 1954. Under the doctrine of long-continued contemporaneous administrative construction, this language must be deemed to accurately reflect the Congressional intent.

The Tax Court found, on the basis of the uncontradicted testimony of five eminent practicing accountants, that Thor was *required* by generally accepted accounting principles to write down excess inventory to net realizable value, and that the procedures utilized by Thor for identifying and valuing the excess inventory conformed to generally accepted accounting principles and constituted the best accounting practice in Thor's trade or business. The Commissioner produced no evidence and gave no reason why Thor's inventory procedures did not clearly reflect its income. Thus, the Tax Court's findings required a holding, based on the language of the Regulations under § 446 and § 471, that Thor's income was clearly reflected by its inventory procedures.

Such a holding would be consonant with an unbroken line of decisions of other courts, particularly the decisions of Courts of Appeals for the Fifth, Sixth and Tenth Circuits, as well as an earlier decision by the Seventh Circuit, which hold that, if a taxpayer's inventory procedures conform to generally accepted accounting principles, they constitute the best accounting practice, and therefore clearly reflect income.

The courts below, in disregard of the Congressional intent and the long-continued administrative interpretation, accord the Commissioner the discretion, *independent of any defined standard*, to determine that a taxpayer's accounting procedures do not clearly reflect income. This discretion is founded principally on the interrelated misconceptions that the prepaid income cases, *Schlude* v. *Commissioner*, 372 U. S. 128 (1963), and *American Automobile Ass'n* v. *United States*, 367 U. S. 687 (1961), give the Commissioner the authority to ignore generally accepted accounting principles even in the inventory area, which

was not involved in those cases; that financial accounting does not adequately measure annual income; and that case law establishes the rule that the Commissioner's determination in inventory accounting matters will not be set aside unless it is "plainly arbitrary". None of these propositions is supported by the authority cited by the Seventh Circuit or the Tax Court.

Independent of the presumptions of the Regulations, Thor's inventory procedures did clearly reflect its income. Based on the decided cases, the requirements of financial accounting, proven by the expert testimony, and the rules of the Securities and Exchange Commission, which are designed to insure the accuracy of published financial statements, Thor's writedown of inventory to net realizable value was required to clearly reflect its income. If, on the contrary, its excess inventory were not written down until it is scrapped, as the Commissioner would require, Thor's income would be overstated in the year the excess should have been written down and understated in the year it was eventually scrapped.

Thus, the scrapping test insisted on by the Commissioner, which the Seventh Circuit held did not constitute an abuse of his discretion, would violate generally accepted accounting principles, and the S. E. C. would treat published financial statements based on it as "misleading or inaccurate". It follows that the scrapping test would not constitute the "best accounting practice" of Thor's trade or business, nor clearly reflect its income, as is explicitly required of inventory procedures by § 471.

According to the lower courts' analysis, even though a taxpayer's inventory procedures conform to generally accepted accounting principles and constitute the best accounting practice, they do not clearly reflect income unless they are explicitly authorized by the specific provisions of the Regulations. This theory is contrary to the decided cases and to the established practice of the Commissioner, who for over 50 years permitted taxpayers to accumulate inventory costs under standard cost systems even though they were not explicitly authorized by the

Regulations. But most importantly, if silence of the Regulations concerning a procedure means that it *does not* clearly reflect income, this would nullify the presumption of § 1.471-2(b) of the Regulations that an inventory procedure which conforms to the "best accounting practice" *does* clearly reflect income.

Even though the Regulations do not explicitly authorize the writedown of excess inventory, the specific provisions providing for the writedown of subnormal goods (§ 1.471-2(c)) and of normal goods to "market value" (§ 1.471-4) do authorize such writedowns—if they are construed to fulfill the intention of § 471 that inventory procedures for tax purposes are to follow the best accounting practice.

Bad Debt Issue

At the end of 1965, after careful review of each of its accounts over $100, Thor's management decided that an addition to its reserve for bad debts of $168,588 was necessary, principally because of the existence of some $184,000 of long-overdue accounts that Thor determined were uncollectible. The Commissioner did not challenge the accuracy of Thor's determinations, but, without explanation, limited Thor's addition to its reserve by a formula which applied a six-year average of Thor's bad debt chargeoffs to the balance of its receivables at the end of 1965.

Section 166(c) of the Code provides that a taxpayer who has elected the reserve method ". . . shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a *reasonable* addition to a reserve for bad debts" (emphasis added). Treasury Regulation § 1.166-4(b)(1) specifies that:

> "What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. . . ."

The six-year historical average emanates from *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other issues*, 125 F. 2d

977 (6th Cir. 1942), *acq.* 1944 C. B. 3, in which the taxpayer produce no evidence explaining how it computed its bad debt reserve. In its opinion, the Board of Tax Appeals made it clear that it was not adopting a *per se* standard of what was reasonable, because a formula cannot take into account the particular facts or circumstances affecting the collectibility of the taxpayer's accounts at the end of each year.

The *Black Motor* formula should be confined to situations similar to that in the case from which it originated inasmuch as the formula itself can yield arbitrary results because it directly depends on the bad debt *chargeoff policies* of the taxpayer, which need not be related to the taxpayer's actual bad debt experience or prospects. The fact that the formula is based on chargeoffs is contrary to the clear Congressional intent when it amended the companion provision of § 166(a) in the Revenue Act of 1942 to eliminate the requirement that a taxpayer could not deduct a wholly worthless bad debt until it was written off.

Contrary to the decisions of the Courts of Appeals for the First, Sixth and Ninth Circuits, and the Tax Court, which have held that the Commissioner abused his discretion when he failed to take into account the particular facts and circumstances affecting the accounts receivable at year-end as required by the Regulations, the decisions of the courts below go farther than any reported case in conferring upon the Commissioner *carte blanche* authority to impose the *Black Motor* historical charge-off formula without regard to the taxpayer's current data on the collectibility of its receivables.

The Commisioner's Discretion

The separate inventory and bad debt valuation issues presented by this case have as their common denominator the extent of the Commissioner's "discretion" in administering the Internal Revenue Code. *Cf. Central Illinois Public Service Co.* v. *United States,* 98 S. Ct. 917 (1978).

On one hand, the Commissioner takes the position that a taxpayer cannot write down unsalable inventory to net realizable value prior to the year when it is scrapped because the Treasury Regulations do not expressly authorize such a writedown. At the same time, the Commissioner ignores the Regulations which require him to consider the current collectibility of a taxpayer's accounts receivable in determining whether a taxpayer's addition to its reserve for bad debts is reasonable.

Despite this inconsistency, the courts below upheld the Commissioner on both issues on the ultimate basis that the taxpayer did not show that the Commissioner had abused his discretion. This conclusion was reached notwithstanding the fact that the Commissioner has offered no explanation to Thor or to either court how Thor's inventory or bad debt valuation procedures were inaccurate or distorted its taxable income.

The lower courts have thus accorded the Commissioner an almost absolute discretion to determine whether or not a taxpayer's inventory and bad debt valuation procedures clearly reflect taxable income. This discretion is granted not to defend the revenues against a tax avoidance scheme or to cope with a unique factual situation, but to invalidate customary inventory and bad debt valuation procedures used by an ordinary manufacturer pursuant to generally accepted accounting principles, as required by his independent public accountants and the S. E. C. Such unprecedented discretion is difficult to reconcile with common law and constitutional foundations which require the law to be administered according to established standards rather than by *ad hoc* administrative determinations.

ARGUMENT

I.

SECTIONS 446 AND 471 OF THE CODE, AND THE TREASURY REGULATIONS PROMULGATED THEREUNDER, PERMIT THE TAXPAYER, IN ACCORDANCE WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND THE BEST ACCOUNTING PRACTICE, TO WRITE DOWN EXCESS AND UNSALABLE GOODS IN ITS INVENTORY FROM COST TO NET REALIZABLE VALUE WITHOUT HAVING TO SCRAP THEM

The decisions of the courts below on the inventory issue are the first, so far as Thor can ascertain, in which any court has held that the Commissioner has virtually *carte blanche* discretion to set aside inventory valuation procedures used by a taxpayer in calculating his taxable income, even though such procedures, consistent with § 446 of the Code, fully conform to generally accepted accounting principles, and constitute "the best accounting practice" in the taxpayer's trade or business within the meaning of § 471 of the Code. The courts' conclusion is not supported by the language of either Code section, and is contrary to their legislative history, as well as to the language of the Treasury Regulations interpreting them.

In recent years, without any change in the Code or applicable Treasury Regulations, the Commissioner commenced disallowing writedowns of excess and unsalable inventory prior to the year when such inventory is scrapped. This policy adversely affects thousands of manufacturers of most products, as well as wholesalers and retailers of them, who must maintain extensive stocks of replacement parts to serve the needs of their customers. A few examples are manufacturers and dealers of factory, construction and farm machinery; automobiles and other vehicles;

computers and office equipment; household appliances; and television and audio products. Because it is impossible to accurately predict how frequently a particular part is going to wear out, break or malfunction, service parts customarily are produced and stocked in quantities exceeding the number that eventually will be sold. These excess parts are retained in inventory until there is little or no customer demand for them, at which time they are scrapped.

The Commissioner's position—that excess inventory cannot be written down until it is scrapped—leaves the manufacturer with an unattractive Hobson's choice: either the unsalable inventory must be carried for years at its cost instead of net realizable value, thereby overstating taxable income by such overvaluation until it is scrapped, or the excess inventory must be scrapped prematurely to the detriment of the manufacturer and its customers. The manufacturer must make this choice even though it has been writing down excess inventory for years according to customary industry practice without any objection from the Commissioner. In fact, at one time Internal Revenue Service auditors would approve such a writedown if the taxpayer could establish its accuracy. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, 23 N. Y. U. Institute on Federal Taxation 839, 850 (1965).

The issues in this case run deeper than the specific inventory valuation question here presented, even though that in itself involves significant tax liability to thousands of businesses. A fundamental policy issue is whether tax accounting should follow generally accepted accounting principles where the taxpayer's procedures are required by normal business needs and are not motivated by tax avoidance. This was the original intention of Congress when it enacted the Revenue Act of 1918, clearly reiterated by it when the 1954 Code was adopted. If, except for express statutory exceptions,* tax accounting conformed

* See, *e.g.*, § 174 (research and experimental expenditures); § 169 (amortization of pollution control facilities); § 616 (expenditures for developing natural resources).

to generally accepted accounting principles, taxpayers would obtain the great benefit of predictability. The Commissioner would receive a reciprocal benefit in that independent public accountants would be professionally obligated, in performing their audit functions, to ensure that their clients' accounting methods and procedures consistently satisfied a single standard applicable equally to both financial and tax accounting.*

An even more basic policy matter is whether the Commissioner should have virtually *ad hoc* discretion in administering such sections of the Code as § 446 and § 471. The Commissioner asserts that Thor's writedown of excess inventory does not clearly state its taxable income, but he has offered no explanation to Thor, or to the courts below, how it does not—or why it was necessary, or even reasonable, for tax accounting to depart from generally accepted accounting principles in valuing excess inventory. Although Thor knows of no established standard other than generally accepted accounting principles for determining whether or not inventory procedures clearly reflect income, this objective standard is treated as irrelevant by both lower courts in favor of an unexplained determination by the Commissioner that Thor's procedures did not clearly reflect its income. In a somewhat different context, this Court recently pointed out that the Commissioner does not have "unfettered discretion," but must look to the intent of Congress in administering the Code, *Central Illinois Public Service Co.* v. *United States*, 98 S. Ct. 917 (1978), especially concurring opinion by Brennan, J., *id.* at 923.

* Since the United Kingdom adopted its first income tax shortly after the American Revolution, it has placed primary responsibility upon chartered accountants in seeing to it that their clients correctly report their income for tax purposes. This system is mutually praised as both protecting the revenues and enhancing taxpayer morale in a country which, similar to the United States, imposes an income tax at high rates on a self-assessment basis. It is also noteworthy that, with statutory exceptions, the definition of "chargeable profits" is based on the concepts of financial accounting. See *Odeon Associated Theatres Ltd.* v. *Jones (Inspector of Taxes)*, [1972] 1 All E. R. 681; [1972] 2 W. L. R. 331.

A. Thor's Writedown of Excess Inventory to Net Realizable Value, Which Is Required by Generally Accepted Accounting Principles and Constitutes the Best Accounting Practice in Thor's Trade or Business, Is Presumed by Sections 446 and 471 of the Code, as Interpreted by Treasury Regulations Thereunder, to Clearly Reflect Thor's Taxable Income

Inventory procedures are subject both to the rules of § 446, which govern tax accounting generally, and to the more specific standards of § 471, which regulate the determination of inventories.

Section 446 imposes the requirement that the method of accounting by which the taxpayer keeps his books is to be followed for income tax purposes unless it "does not clearly reflect income". Section 471 applies a dual standard that a taxpayer's inventory must conform "as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income".

The legislative history of these statutory provisions, and of the Treasury Regulations interpreting them, clearly establishes that the two concepts of generally accepted accounting principles and clearly reflecting income are related and not antithetical. Since the Revenue Act of 1918, the Regulations have recognized that conformance to generally accepted accounting principles (prior to the 1954 Code, "approved standard methods of accounting") will "ordinarily" or "as a general rule" be regarded as "clearly reflecting income", and the Committee Reports accompanying the 1954 Code in almost *haec verba* stated that to be the intent of Congress.

The requirements of both sections of the Code were fulfilled when the Tax Court found that generally accepted accounting principles required Thor to write down its excess inventory to net realizable value, and that Thor's procedures for doing so conformed to generally accepted accounting principles and

constituted the best accounting practice in its trade or business (Pet. A-15, A-19–A-20, quoted at pp. 13-14, *supra*). Inasmuch as the Commissioner introduced no evidence whatsoever that Thor's inventory valuation procedures did not clearly reflect its income, the findings of the Tax Court should be dispositive of the inventory issue as a matter of law.

I.

Section 446(a) of the Code states in mandatory language:

> "Taxable income *shall* be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." (Emphasis added.)

Section 446(b) permits the Commissioner to require a different method of accounting only if the taxpayer's method "does not clearly reflect income".* Otherwise the taxpayer's accounting method, including "the accounting treatment of any item" (Treas. Reg. § 1.446-1(a)(1)) such as Thor's writedown procedures for excess inventory, is controlling for tax accounting purposes.

The initial version of Treasury Regulation § 1.446-1(a)(2) under the 1954 Code interpreted the statute as follows:**

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that

* The House and Senate Committee Reports do not contain any substantive explanation of § 446(b). See H. R. Rep. No. 1337, 83d Cong., 2d Sess. A157-58 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 299-300 (1954).

** T. D. 6282 (filed December 24, 1957), 1958-1 C. B. 215, republished without change in T. D. 6500 (filed November 25, 1960), 25 Fed. Reg. 11708 (1960).

> trade or business *will ordinarily be regarded as clearly reflecting income*. . . ." (Emphasis added.)

The final sentence of this excerpt is almost identical to that in the discussion of § 446 in the Reports of the House and the Senate accompanying the 1954 Code, H. R. Rep. No. 1337, 83d Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954), both of which state:

> "A method of accounting which reflects the consistent application of generally accepted accounting principles in a trade or business will ordinarily be considered as clearly reflecting income."*

The substance of both the statutory and regulatory provisions originates with the Revenue Act of 1918 and Treasury Regulations 45 interpreting it. Section 212(b) of that Act, 40 Stat. 1057, 1064 (1919), provided:

> "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but . . . if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income. . . ."

Except for minor editorial changes, identical language appeared in all subsequent Revenue Acts and § 41 of the Code of 1939.

* The Congressional Reports are consistent with the ALI Federal Income Tax Statute (February 1954 Draft), which was the origin of the accounting provisions of the 1954 Code. See Austin, Surrey, Warren and Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 Harv. L. Rev. 257, 291 n.122 (1954). The ALI's explanation of § X310(a), which became § 446 of the Code, declares at p. 400:

> "This provision sets forth the general approach to tax accounting. It indicates the general dependency of tax accounting on general accounting practice in that the taxpayer's method of accounting for business purposes, subject to certain conditions, is to be his method for determining the time for inclusion and deduction in computing his taxable income."

The substantive concepts of the current Regulation § 1.446-1 (a)(2) under the 1954 Code can be traced to the original Treasury Regulations 45 interpreting the 1918 Act. Article 23 of those Regulations provided: "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income."* This language was readopted in all subsequent editions of the Regulations through Regulations 118, § 39.41-2 (1953) under the 1939 Code.

The history of the statute and Regulations is succinctly summarized by Austin, Surrey, Warren and Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 Harv. L. Rev. 257, 258 (1954):**

> "Since the advent of the present federal income tax, it has quite apparently been the basic intention that generally accepted accounting principles should govern determinations of taxable income."

The authors observe critically that the intention of Congress was not followed in judicial and administrative interpretations of the Revenue Acts and the 1939 Code, and that these de-

* Article 24 of those initial Regulations contained the language now found in the opening sentences of § 1.446-(1)(a)(2), quoted at p. 28 *supra:*

> "It is recognized that no uniform method of accounting can be prescribed for all taxpayers, *and the law contemplates* that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose." (Emphasis added.)

Both Articles 23 and 24 appeared in the "preliminary" edition of Regulations 45, published as House Document No. 1826, 65th Cong., 3d Sess. (1919), primarily intended for use by members of the House. This language was republished in each of the four succeeding editions of Regulations 45, including the edition issued January, 1921, by T. D. 3146, known as the "1920 Edition".

** The authority of this article is enhanced by the fact that Messrs. Surrey and Warren were co-reporters of the ALI Federal Income Tax Statute, which was the origin of the accounting provisions of the 1954 Code. See footnote p. 29 *supra.*

partures provided the impetus for the accounting provisions of the 1954 Code.*

Since the adoption of the 1954 Code the courts have followed the renewed Congressional intention at least as to inventory matters. Thus, until the decisions below, Thor can find no case in which the Commissioner has successfully invoked § 446(b) to invalidate a taxpayer's inventory procedure which conformed to generally accepted accounting principles.**

2.

Section 471 of the Code, specifically governing inventory accounting, provides:

> "Whenever . . . the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

This language imposes dual requirements *on both the taxpayer and the Commissioner*. Inventory accounting must: (i) conform

* "This early recognition that it was the purpose of the statute to give effect to basic accounting principles was greatly qualified in important particulars by later judicial and administrative interpretations. [See especially *North Am. Oil Consol.* v. *Burnet*, 286 U. S. 417 (1932).] The development of these interpretations, at variance with commercial accounting principles, is not within the scope of this article. The consequence of the process, however, has been certain serious divergences between rules of tax accounting and generally accepted accounting principles as universally applied in determining net income for commercial management and investment purposes. These divergences were a continuous source of irritating adjustments, which, in the long run, yielded no substantial revenue to the Government because they merely represented shifts of income between years. They provided the background and impetus for the 1954 Code Revision." (Bracketed portion originally in footnote.) 68 Harv. L. Rev. at 258.

** The cases cited by the Tax Court (Pet. A-20–A-21) and by the Seventh Circuit (Pet. A-38, A-40) all involved inventory methods which the courts properly found did *not* conform to generally accepted accounting principles. See discussion at p. 51 *infra.*

as nearly as may be to the best accounting practice in the taxpayer's trade or business, and (ii) clearly reflect the taxpayer's income.

After discussing these two criteria, Treasury Regulation § 1.471-2(b), in effect for the year in question and at the time of trial, stated:

> "It follows, therefore, that *inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business.* In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§ 1.471-1 through 1.471-9. *An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.*" (Emphasis added.)*

Just as the Regulations under § 446 state that a method of accounting that conforms to generally accepted accounting principles "ordinarily" will be regarded as clearly reflecting income, the Regulations interpreting § 471 declare that an inventory that qualifies as the best accounting practice can "as a general rule" be regarded as clearly reflecting income.

The origin of § 471 (like § 446) is the Revenue Act of 1918. The language of § 471 repeats almost verbatim § 203 of that

* After trial of this case but before the Tax Court decision, that Regulation was amended by T. D. 7285 (filed September 14, 1973), 1973-2 C. B. 163, to delete the last sentence quoted above. That amendment also deleted the word "substantially" in the penultimate sentence, thus requiring that inventory valuation must be "in accord" with the enumerated specific provisions of the Regulations.

Both courts below, relying on *Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939), properly held that the amendment was not applicable to this case (Pet. A-22 and A-39).

Act,* and essentially the same language has been in all intervening Revenue Acts and § 22(c) of the 1939 Code.**

As passed by the House, § 203 did not contain the phrase "as conforming as nearly as may be to the best accounting practice in the trade or business." This language was added by a Senate amendment to the Bill and was adopted in conference without significant discussion. H. R. Rep. No. 1037, 65th Cong., 3d Sess. 45 (1918), 1939-1 C. B. (Part 2) 132. When this same provision was before Congress in the Bill that later became the Revenue Act of 1921, 42 Stat. 227, 231 (1921), there was floor debate in the Senate as to the meaning of the language. Senator Penrose, a member of the Senate Finance Committee and floor leader of the Bill, stated unequivocally that "the law compels the Internal Revenue Department to compel the taxpayer to follow the best accounting practice."***

* Section 203 of the 1918 Act, 40 Stat. 1057, 1060 (1919) provided:

> "That whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe *as conforming as nearly as may be to the best accounting practice in the trade or business* and as most clearly reflecting the income." (Emphasis added.)

** Section 471 is a renumbering, without substantive change, of § 22(c) of the 1939 Code. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. A164 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 307 (1954).

*** The floor debate included the following colloquy:

> "MR. KING: Mr. President, may I inquire of the committee . . . whether it is the purpose of this amendment to authorize the commissioner to determine the form of inventory which shall be followed by all business houses in the United States that would be subject to these provisions, regardless of the efficiency and honesty of the methods pursued by business houses in carrying their inventories and ascertaining their liabilities, assets, and so forth?
>
> "MR. PENROSE: Mr. President, the provision is existing law, without any alteration, and is now being administered without any great complaint having been called to my attention.

(Footnote continued on next page.)

The origin of the language of § 1.471-2(b) of the Regulations, quoted at pp. 31-32 *supra*, first appeared in Article 1582 of the 1920 Edition of Regulations 45, as amended by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922):*

> "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income."

This language remained unchanged in substance through all intervening Regulations for 53 years until September, 1973,

(Footnote continued from preceding page.)

Where the books of a concern are accurate and kept in a businesslike way I am informed that they are accepted by the Treasury Department without question.

"* * *

"MR. PENROSE: *The law says that the best accounting practice in the trade or business is to be followed. That is all that is necessary.* There is no trouble about this.

"MR. KING: Let me say to the Senator that there have been some complaints.

"MR. PENROSE: There may be.

"MR. KING: Not many have been brought to my attention, but some, that arbitrary requirements have been made by the department with respect to the form of inventories. Certain businesses have established a method of inventorying their business which have met their requirements, and which are regarded by them and by others as being fair and honest, and a true reflection of the condition of the business; and it has been felt by some that to abandon accepted standards of business, adopted by business men, to conform to the whims and caprices—and I do not use those terms at all offensively—of officials works a very serious hardship.

"MR. PENROSE: Mr. President, if the Senator will pardon the expression, let me take absolute issue with him on that point. *The department does not make any arbitrary rules of accounting. The law compels the Internal Revenue Department to compel the taxpayer to follow the best accounting practice. They do not put their arbitrary methods in force. . . .*" (Emphasis added.) 61 Cong. Rec. (Part 6) 5809 (1921).

* In A. R. R. 921, I-1 C. B. 126 (1922), Article 1584 as amended by T. D. 3296, was applied to the years 1917 and 1919, thus indicating that the amendment was effective retroactively to the outset of Regulations 45.

after the trial of this case but before the Tax Court's decision, when the very sentence upon which Thor relies was deleted from the Regulation. See fn. at p. 32 *supra*. There was no legislation nor any court decision requiring or even supporting this restrictive amendment to the Regulation.

During the 60 years from the enactment of the 1918 Act until the decisions of the courts below, to Thor's knowledge no court has held that a taxpayer's inventory procedure which constituted the best accounting practice in the taxpayer's trade or business did not clearly reflect the taxpayer's income.*

3.

The history of both § 446 and § 471, and of the Treasury Regulations interpreting them, presents a classic case for applying the doctrine of long-continued contemporaneous administrative construction.

This Court consistently has held that when an agency charged with the administration of a statute has construed that statute contemporaneously with its enactment, and has applied that interpretation uniformly for a substantial period of time, the original interpretation will be followed notwithstanding a subsequent attempt by the administrative agency to change it.

Leading authority is *United States* v. *Leslie Salt Co.*, 350 U. S. 383 (1956). In holding that the Treasury could not reverse its long-standing interpretation that certain types of promissory

* The cases cited by the Tax Court (Pet. A-20–A-21) and by the Seventh Circuit (Pet. A-38, A-40) all involved inventory methods which the courts properly found did not conform to generally accepted accounting principles and did not constitute the best accounting practice. See discussion at p. 51 *infra*.

The cases invalidating the LIFO method, *e.g., Marshall-Wells Co.* v. *United States*, 59 F. 2d 106 (Ct. Cl. 1932); I. T. 1560, II-1 C. B. 29 (1923), are not an exception to the statement in the text because the LIFO method of accounting was not approved as a generally accepted accounting principle until July, 1947, by Accounting Research Bulletin No. 29 of the AICPA Accounting Principles Board.

notes were not "debentures" or "certificates of indebtedness" and therefore were not subject to Federal documentary stamp taxes, this Court stated, *id.* at 396-97:

> "There are persuasive reasons for construing 'debentures' and 'certificates of indebtedness' in accordance with the Treasury's original interpretation of those terms in this statute's altogether comparable predecessors. In *Norwegian Nitrogen Prod. Co.* v. *United States,* 288 U.S. 294, 315, Mr. Justice Cardozo said:
>
> > " 'administrative practice, consistent and generally unchallenged, will not be overturned except for very cogent reasons if the scope of the command is indefinite and doubtful. . . . The practice has peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new.'
>
> "Against the Treasury's prior longstanding and consistent administrative interpretation its more recent *ad hoc* contention as to how the statute should be construed cannot stand."

See also *Cory Corp.* v. *Sauber,* 363 U. S. 709, 712 (1960) (*per curiam*); *Fribourg Navigation Co.* v. *Commissioner,* 383 U. S. 272, 283 (1966), and *Canada Packers, Ltd.* v. *Atchison, T. & S. F. Ry.,* 385 U. S. 182, 183-84 (1966) (*per curiam*).

The force of the rule is enhanced when Congress has reenacted the statutory section unchanged while the administrative precedent construing it is accumulating. In *Fribourg Navigation Co.* v. *Commissioner, supra,* this Court stated, 383 U. S. at 283:

> "Over the same extended period of years during which the foregoing administrative and judicial precedent was accumulating, Congress repeatedly re-enacted the depreciation provision without significant change. Thus, beyond the generally understood scope of the depreciation provision itself, the Commissioner's prior long-standing and consistent administrative practice must be deemed to have received congressional approval. See, *e.g., Cammarano* v. *United States,* 358 U.S. 498, 510-511; *United States* v. *Leslie Salt Co.,* 350 U.S. 383, 396-97; *Helvering* v. *Winmill,* 305 U.S. 79, 83."

The original administrative construction by the Treasury under both § 446 and § 471 remained unchanged for over a half-century through 12 reissuances and many amendments of the Regulations. During this period the statute was reenacted seven times as Revenue Acts, codified in 1939, and recodified in 1954. This history is strong confirmation that Congress has approved the original interpretation of the Treasury Regulations under both sections that if a taxpayer's accounting method embodies generally accepted accounting principles and constitutes the best accounting practice, it "ordinarily" or "as a general rule" will be regarded as clearly reflecting income.*

Whether these long-continued and parallel interpretations of § 446 and § 471 by the Treasury Regulations are regarded as establishing either a general rule or a rebuttable factual presumption under each section, they clearly reflect the original Congressional intention, unmistakably renewed under the 1954 Code. This being so, these interpretations cannot simply be ignored as both the Commissioner and the lower courts have done in this case.

* * *

The findings of the Tax Court that Thor's procedures for writing down excess inventory both conformed to generally accepted accounting principles and constituted the best accounting practice in Thor's trade or business, entitled Thor to the

* That the Treasury understood the Congressional intention this way is confirmed by the initial Regulations it issued under the 1954 Code. Regulation § 1.446-1(a)(2), promulgated by T. D. 6282 (filed December 24, 1957), 1958-1 C. B. 215, which incorporated the very language of the House and Senate Committee Reports, quoted at pp. 28-29 *supra.* Similarly, Regulation § 1.471-4(b), promulgated by T. D. 6336 (filed December 1, 1958), 1958-2 C. B. 176, continued the same language that first had been in Regulations 45, quoted at p. 34, *supra.*

benefit of the presumptions or general rules under both statutory sections. Inasmuch as the Commissioner introduced no evidence which rebutted them or showed that an exception should apply, they established under both sections that Thor's taxable income was clearly reflected. This should have determined the issue.

B. The Courts Have Uniformly Held, Consistent with the Congressional Intention, That a Taxpayer's Income Is Clearly Reflected by Accounting Procedures That Conform to Generally Accepted Accounting Principles and Constitute the Best Accounting Practice

The Courts of Appeals for the Fifth, Sixth and Tenth Circuits, as well as trial courts, have sustained the Congressional intention by uniformly holding that a taxpayer's inventory method clearly reflects income if it conforms to generally accepted accounting principles and constitutes the best accounting practice. In fact, the Seventh Circuit adopted this position in an earlier decision.

In *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N. D. Ohio 1963), in which the Sixth Circuit adopted the District Court's opinion, 351 F. 2d 449 (6th Cir. 1965), a taxpayer was permitted to write down to net realizable value partially completed presses being built to a customer's specifications under a fixed price contract. The District Court stated, 224 F. Supp. at 382:

> "An evaluation of the evidence outlined above leaves no room for doubt that plaintiff's method of valuing its work in process inventory is in harmony with generally accepted accounting principles. . . . These conclusions are compelled by . . . the testimony of the taxpayer's witnesses, all of whom are certified public accountants of wide and extensive experience in auditing accounts of large publicly owned corporations. . . .
>
> "It was established also that an inventory valued in accordance with generally accepted accounting principles may be considered as one that conforms 'as nearly as may be to the best accounting practice in the trade or business.' "

The Commissioner argued that adherence to generally accepted accounting principles did not necessarily lead to the conclusion that the taxpayer's income was clearly reflected, to which the District Court responded, *id.* at 385:

> "I hold that the plaintiff [taxpayer] has shown by the requisite degree of proof that the Commissioner acted arbitrarily in disallowing the write-down of plaintiff's inventory. . . .
>
> "* * *
>
> "I find further that the inventory was used under the best accounting practice in a balance sheet showing the financial position of the taxpayer and under the *general* rule applicable in such cases is considered as clearly reflecting taxpayer's income." (Emphasis added.)

In *Space Controls, Inc.* v. *Commissioner,* 322 F. 2d 144 (5th Cir. 1963), *rev'g* 21 T. C. M. (CCH) 295, P-H TC Mem. Dec. 62-336 (1962), the Fifth Circuit held that a taxpayer incurring a loss in manufacturing military trailers under a fixed price contract was entitled to write down its closing inventory to net realizable value. The Court specifically rejected the Commissioner's arguments, *almost identical to the ones made by him in this case,* that no writedown was permitted because all of the specific requirements of the Regulations were not fulfilled; the goods were not damaged or imperfect; the net realizable value was less than replacement cost; and the loss had not been "realized" because the goods had not yet been delivered.

Describing the following as the "heart of the case", the Court stated, 322 F. 2d at 149:

> "The Regulations echo the statutory emphasis on inventory methods 'conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.' 26 U.S.C.A. § 471; Regulation § 1.471-2. Considering the sharply defined rule that

accounting may be different for business-financial purposes and for tax purposes, the Regulations here accord extraordinary tax significance to financial accounting of inventories. 'An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.' Regulation § 1.471-2(b)." (Footnote omitted.)

It concluded its opinion, *id.* at 154-55, with the observation that ". . . it would hardly be a true reflection of the financial condition of that concern were its inventory of dedicated goods valued at an amount which it could never get."

Monfort of Colorado, Inc. v. *United States*, 561 F. 2d 190 (10th Cir. 1977), *aff'g* 406 F. Supp. 701 (D. Colo. 1976), presented the issue whether gains and losses from cattle futures contracts, purchased by the taxpayer to hedge its cattle inventory costs, could properly be used to adjust closing inventory values. The taxpayer's position was that these gains or losses decreased or increased its inventory cost of the cattle. After finding that the taxpayer's inventory method was consistent with generally accepted accounting principles, *id.* at 196, the Tenth Circuit upheld it, stressing that its decision was ". . . in keeping with the regulatory mandates that valuations of inventory must necessarily be flexible in order to give effect to trade customs. . . ." *Ibid.* The Court also found that because the taxpayer's method was an "acceptable accounting method" it clearly reflected income, *id.* at 198.

An earlier decision of the Seventh Circuit—unmentioned in the opinion below, although it was referred to in Thor's brief—adopted the same view as the other Circuits. *Van Pickerill & Sons, Inc.* v. *United States*, 445 F. 2d 918, 920-21 (7th Cir. 1971), *aff'g* 70-1 U. S. Tax Cas. 83,406, 25 Am. Fed. Tax R. 2d 70-1232 (S. D. Ill. 1970), involved the issue whether storage costs and state liquor taxes on whiskey being aged could properly be excluded by the taxpayer from the inventory value

of the whiskey. In holding that it was acceptable to do so, a different panel of the Seventh Circuit reasoned:

"Section 471 provides that the accounting method prescribed should conform as nearly as possible to the best accounting practice in the trade or business and more clearly reflect income. Both the taxpayer and the government introduced the opinions of noted experts on the question of the 'best accounting practice' leading the district court to conclude that 'no uniform method of accounting can be prescribed for all taxpayers.' The government argues that this conclusion is erroneous since use of the superlative 'best' in Section 471 allows but one acceptable accounting method. *We do not believe, however, Congress intended the federal judiciary to decide, as a matter of law, accounting disputes* where there is a wide diversity of expert opinion. *Congress has so indicated by using the phrase 'conforming as nearly as may be * * *'* is Section 471. Paragraph 1.471-2(b) [of the Treasury Regulations] . . . lends additional support: *'Inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business.'* . . . We agree with taxpayer that no one accounting principle or case supports the government position since there is no one, single definition of costs." (Emphasis added.)*

The *Van Pickerill* decision is particularly significant because the Seventh Circuit approached that case on the premise that if the taxpayer's procedures were the "best accounting practice," that would determine that its income was clearly reflected. The difference between the parties was the Government's contention, rejected by the court, that there was only one "best accounting practice" which the taxpayer had not followed. If, in the instant case, the Seventh Circuit had followed *Van Pickerill*, it would have held that Thor's inventory procedures clearly reflected its income because Thor's expert testimony established (in contrast to *Van Pickerill* where there was conflicting accounting testi-

* This passage was quoted and followed by the Tenth Circuit in *Monfort of Colorado, Inc.* v. *United States*, *supra*, 561 F. 2d at 196.

mony), and the Tax Court found, that Thor's inventory procedures constituted the best accounting practice in its trade or business.*

In an early case, *Lucker* v. *United States*, 53 F. 2d 418, 423-24 (Ct. Cl. 1931), the Court of Claims recognized the Congressional intention and permitted the writeoff of worthless phonograph records, stating, *id.* at 424:

> "Taxation is eminently practical, and we think this is particularly true as to inventories which need only conform to the 'best accounting practice in the trade or business and as most clearly reflect the income.' Not only do we think good accounting practice would require the exclusion of the entire stock of worthless records, but also that a closing inventory at December 31, 1920, *which included these records at any value to the plaintiff, would result in income not being clearly reflected.*" (Emphasis added.)

Fides Publishers Ass'n v. *United States*, 263 F. Supp. 924 (N. D. Ind. 1967) is the only reported case involving excess inventory. There the Commissioner conceded that a publisher was entitled under § 471 to write down an excess stock of books to clearly reflect taxable income, but questioned the taxpayer's formula. The District Court, *id.* at 936, permitted the write-down:

> "It *is conceded that the write-off of such unsalable inventory is proper to accurately reflect net income.* It is allowed by Section 471 of the Internal Revenue Code of 1954, and further it is a customary practice for the book publishing industry. . . . The Government's principle [sic] objection, then, is that the method employed to recompute inventory was improper.
>
> "The inventory write-off was accomplished in the following manner: from the actual inventory on hand was deducted that quantity of books which the taxpayer anticipated would be sold over the next two-year period. The

* *Van Pickerill* is similar to the instant case in another respect because the Treasury Regulation § 1.471-3(c) in effect at that time was silent as to whether or not state taxes and storage costs were to be capitalized in the inventory value.

> remaining inventory was written off as obsolete. The Government . . . attacks the use of a two-year sales period for books of a religious nature which, it is claimed, have a longer useful life than ordinary commercial publications. However, the Government *presented no evidence on the issue* and, to the contrary, the taxpayer's qualified accountant testified that a two-year evaluation of future sales was 'fair for the type of titles you have here.' *This argument, then, has no merit, especially in light of the Government's own Treasury Regulation* § 1.471-2 *which provides that inventory rules must 'give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business.'*" (Emphasis added.)

As the testimony of the expert accountants established (A103-A104, A129-A130, A155-A156, A174, A190-A192), it is customary for manufacturers of parts to write down excess inventory quantities to their net realizable value.

See also *Lord Motor Car Co.*, 5 B. T. A. 818, 820 (1926), *acq.* VI-2 C. B. 4 (1927), in which a dealer wrote down used cars by 25% of his cost to what he estimated was fair market value at the time of the inventory. The Tax Court held that the taxpayer's inventory valuation was in conformity with the statute and Article 1582 of Regulations 45 and clearly reflected income.

Two themes can be discerned in these cases. Dominant is acceptance of the Congressional intention that tax accounting, particularly in the complex inventory area, should look to the sophisticated standards of generally accepted accounting principles. Supporting this, the courts, echoing the language of the Regulations, repeatedly refer to "trade customs" and "customary accounting practices" in the particular trade or business. From this viewpoint, the courts have easily concluded that inventory procedures that constitute the best accounting practice in the taxpayer's particular trade or business clearly reflect the taxpayer's income.

C. The Decisions Below Permit the Commissioner to Arbitrarily Determine, Contrary to the Standards Imposed by Sections 446 and 471 and by the Treasury Regulations Thereunder, That Thor's Inventory Procedures Did Not Clearly Reflect Its Income

The Seventh Circuit decision nullifies the intention of § 446 and § 471 and the language of the Treasury Regulations by giving the Commissioner discretion, independent of any defined standard, to determine that a taxpayer's accounting procedures do not clearly reflect its income. According to the Court, the general rule of § 446 need not be applied: "If . . . in the *opinion* of the Commissioner, that method [of the taxpayer] does not clearly reflect income, the Commissioner may require that another method be used" (emphasis added) (Pet. A-38).* As to § 471, the Court says ". . . the accounting profession's indorsement of a practice as 'the best accounting practice,' even if accepted by the Commissioner, does not require him to determine that the practice clearly reflects taxable income" (Pet. A-40). Nowhere in its opinion does the Seventh Circuit indicate what standard the Commissioner is to follow in determining (i) that the presumptions of both sections of the statute are not to be followed or (ii) that the taxpayer's income is not clearly reflected. The Court's silence is consistent with that of the Commissioner, who nowhere in the pleadings, evidence or briefs gives any hint how Thor's inventory procedures failed to clearly reflect its income, but simply repeatedly asserts that they did not.

The Seventh Circuit's position is founded on interrelated misconceptions of case law and the purposes of financial accounting:

(i) that *Schlude* v. *Commissioner*, 372 U. S. 128 (1963), and *American Automobile Ass'n* v. *United States*,

*This is in stark contrast to the language of the statute which requires that the taxpayer's method of accounting be followed unless it does not clearly reflect income—not that it can be rejected *if in the Commissioner's opinion* it does not clearly reflect income.

367 U. S. 687 (1961), accord the Commissioner broad authority to ignore generally accepted accounting principles even in inventory accounting (Pet. A-40);

(ii) that tax accounting need not follow generally accepted accounting principles because financial accounting does not adequately measure income by the annual accounting period as tax accounting requires (Pet. A-40); and

(iii) that case law gives the Commissioner discretion, subject only to not being "plainly arbitrary," to determine that a taxpayer's accounting procedures do not clearly reflect its income (Pet. A-40).

The Court reinforces its position that Thor is not entitled to the usual presumptions of § 446 and § 471 that its accounting procedures clearly reflect income by noting "inferences" in the Tax Court's opinion that Thor's 1964 year-end inventory procedures may not have been consistent with those of earlier years (Pet. A-45).

1.

The Seventh Circuit bases its conclusion—that a finding that the taxpayer's inventory procedure constitutes the best accounting practice does not require a holding that it clearly reflects income—mainly upon the prepaid income cases, *American Automobile Ass'n* v. *United States*, 367 U. S. 687 (1961) and *Schlude* v. *Commissioner*, 372 U. S. 128 (1963).*

* It also relies on a 1930 case, *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264 (1930), in which this Court held that inventories valued according to the "base stock method" did not clearly reflect the taxpayer's income. That inventory method, which is designed to reduce fluctuations in income between years, does not conform to generally accepted accounting principles. It was declared to distort income by T. B. R. 65, I C. B. 51 (1919); Article 1582 of the 1920 Edition of Regulations 45, as amended by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922), reiterated the prohibition; and it continues to be prohibited by Regulation § 1.471-2(f)(4). There is no comparable prohibition of Thor's inventory procedures in the Regulations.

Both cases involved, under § 41 of the 1939 Code and § 446 of the 1954 Code, the narrow issue of whether prepaid service income was taxable to an accrual basis taxpayer in the year when payments were received, or could be deferred and amortized over the years when the services were to be rendered. In two 5-4 decisions, this Court held that such income was taxable when received, partly because the taxpayers were unable to adequately match expenses with the related income, 367 U. S. at 691-94; 372 U. S. at 135-37, but principally because of a unique legislative history which showed that Congress did not intend generally accepted accounting principles to govern this limited area of tax accounting, 367 U. S. at 694-98; 372 U. S. at 134-35.

The prepaid income cases are distinguishable from the instant case on both of the grounds underlying those decisions. In those cases the taxpayer was unable to accurately match revenues with expense; Thor's writedown to net realizable value does match inventory losses with revenues (whereas the Commissioner's scrapping test would not). See discussion at pp. 55-56 *infra*.

The comparative legislative history could not be more disparate. With extremely limited exceptions, the deferral of prepaid income had never been allowed for income tax purposes until the enactment of § 452 in the 1954 Code. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. 62-63, 301-03 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 48-49, A159–A160 (1954). This was *retroactively* repealed a year later by the Act of June 15, 1955, 69 Stat. 134 (1955). Section 471 in contrast has remained unchanged over 50 years. This section, which was not mentioned in the prepaid income cases, makes tax accounting for inventories expressly dependent on the "best accounting practice". If that explicit statutory requirement is to be followed, tax accounting for inventories must be based on generally accepted accounting principles. After the repeal of § 452, there was no equivalent requirement for prepaid income.

Nothing in the opinion of this Court in either prepaid income case suggests in the slightest that it was adopting a general policy that tax accounting was to be independent of generally accepted accounting principles as its progenitive authority, contrary to the clear Congressional intention embodied in § 41 of the 1939 Code and § 446 of the 1954 Code. To the contrary, some 15 years after those decisions, their result is one of the only two major non-statutory exceptions—if they accurately can be called "non-statutory" in light of the legislative history—to the rule that tax accounting follows generally accepted accounting principles.*

The scope of the prepaid income cases may be discerned from a recent decision of this Court, which looked to "accepted accounting methods" to determine whether the substance of a sale-and-leaseback transaction was consonant with its form for purposes of determining who was entitled to certain deductions under § 163(a), *Frank Lyon Co.* v. *United States*, 46 U. S. L. W. 4313, 4317-18 (1978). This Court relied on financial accounting rules even though it noted that "the characterization of a transaction for financial accounting purposes . . . and for tax purposes . . . need not necessarily be the same." *Id.* at 4317.

The Court of Claims cogently appraised the scope of the prepaid income cases in *Cincinnati, N. O. & T. P. Ry.* v. *United States*, 424 F. 2d 563, 570 (Ct. Cl. 1970) (*per curiam*):

> "While the *American Automobile Ass'n* and *Schlude* decisions held that in the limited context of the accounting for received but unearned income the generally accepted method of accounting for such receipts does not clearly reflect income for tax purposes, those cases do not establish a general rule abrogating the presumption of correctness

* The other exception is reserves for expenses to be incurred in the future, which are generally prohibited by tax accounting rules. See, *e.g.*, *Brown* v. *Helvering*, 291 U. S. 193 (1934). This exception has a legislative history parallel to that for prepaid income. As enacted, the 1954 Code included § 462 permitting taxpayers to deduct certain expense reserves that would be permitted under generally accepted accounting principles. This section was repealed retroactively along with § 452 by the Act of June 15, 1955, 69 Stat. 134 (1955).

afforded by the regulations, Treas. Reg. 111, § 29.41-2, Treas. Reg. 1.446-1(a)(2), to generally accepted accounting methods. *Schlude* and *American Automobile Ass'n* are based on the peculiar statutory history of the treatment by Congress of unearned, received income, and on the finding that for tax purposes the generally accepted methods treated such income in an 'artifical' [sic] manner . . ." (Footnote omitted.)

This reasoning led to the holding that, because an I. C. C. rule requiring railroads to expense rather than capitalize purchases of property costing less than $500 was in accordance with generally accepted accounting principles, its application resulted in the railroad's taxable income being clearly reflected. *Id.* at 570-71.

2.

The Seventh Circuit's belief that financial accounting does not measure income by annual periods contradicts common knowledge and all financial accounting authority.*

The American Institute of Certified Public Accountants' ("AICPA") Accounting Principles Board Statement No. 4, entitled "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises," issued October, 1970, declares in Chapter 2:

> "Changes in Financial Position—The Income Statement. The income statement *for a period* . . . presents an indication in conformity with generally accepted accounting

* All excerpts in the text are from opinions of the Accounting Principles Board of the American Institute of Certified Public Accountants. The S. E. C. has announced that these pronouncements of the Board, together with those of its successor, the Financial Accounting Standards Board, constitute "substantial authoritative support" in determining whether financial statements filed under the Securities Act of 1933 and the Securities Exchange Act of 1934 are prepared in accordance with generally accepted accounting principles. S. E. C. Accounting Series Release No. 150 (December 20, 1973), 39 Fed. Reg. 1260 (1974). That same Release states that financial statements not prepared on the basis of such substantial authoritative support will be considered "misleading or inaccurate". See pp. 56-58, *infra*.

> principles of the results of the enterprise's profit-directed activities *during the period*. The information presented in an income statement is *usually considered the most important information provided by financial accounting* because profitability is a paramount concern to those interested in the economic activities of the enterprise." (Emphasis added.)*

Accounting Research Bulletin No. 43 (1961), which the profession regards as the "bible" of what constitutes generally accepted accounting principles (A99–A100), applies those principles to inventory accounting.** Statement 4 of Chapter 4 of ARB 43 specifies:

> ". . . the *major objective* in selecting [an inventory] method should be to choose the one which, under the circum-

* Indeed, if there is a conflict in inventory accounting between accuracy of the income statement, which must show annual income, and accuracy of the balance sheet, the income statement is given preference. This is vividly illustrated in a discussion of the LIFO method of inventory accounting in Chapter 6 of the same Statement of the Accounting Principles Board:

> "172. *Emphasis on Income.* Over the past century businessmen, financial statement users, and accountants have increasingly tended to emphasize the importance of net income and that trend has affected the emphasis in financial accounting. Although balance sheets formerly were presented without income statements, *the income statement has in recent years come to be regarded as the most important of the financial statements. Accounting principles that are deemed to increase the usefulness of the income statement are therefore sometimes adopted by the profession as a whole regardless of their effect on the balance sheet or other financial statements.* For example, the last-in, first-out (LIFO) method of inventory pricing may result in balance sheet amounts for inventories that become further removed from current prices with the passage of time. LIFO, however, is often supported on the grounds that it usually produces an amount for cost of goods sold in determining net income that more closely reflects current prices. This result is believed to compensate for the effect under the LIFO method of presenting inventories in the balance sheet at prices substantially different from current prices." (Emphasis added.)

** Relevant portions of ARB 43 are in the record as Exhibit 28. The binding effect on the accounting profession of formal opinions issued by the Accounting Principles Board is set out in the introductory material to ARB 43. See also fn. at p. 48 *supra*.

stances, *most clearly reflects periodic income.*" (Emphasis added.)

Contrary to the lower courts' view, this objective is identical to that of tax accounting.

Statement 5 of ARB 43 provides:

> "A departure from the cost basis of pricing the inventory is *required* when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the *current period*. This is generally accomplished by stating such goods at a lower level commonly designated as *market*." (First two emphases added.)

In applying Statement 5, Statement 6 states that "market" value of an inventory item cannot exceed its net realizable value:

> "As used in the phrase *lower of cost or market* the term *market* means current replacement cost (by purchase or by reproduction, as the case may be) except that:
>
> > "(1) Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal). . . ."*

The expert witnesses testified that Statements 5 and 6 represent the relevant generally accepted accounting principles governing the valuation of inventory (*e.g.*, A101–A103) and that Thor's procedures conformed to them (see p. 13 *supra*). The Seventh Circuit apparently rejected this accounting authority and expert testimony on the basis of the plainly distinguishable authority of the prepaid income cases and *Lucas* v. *Kansas City Structural Steel Co.*, discussed at pp. 45-48, *supra*.

---

* This definition was expressly approved for tax accounting purposes in *E. W. Bliss Co.* v. *United States, supra,* 224 F. Supp. 374, 379 (N. D. Ohio 1963), *aff'd on the opinion below,* 351 F. 2d 449 (6th Cir. 1965).

3.

The courts below took the position that, even though Thor's inventory valuation procedures conformed to generally accepted accounting principles and constituted the best accounting practice in Thor's trade or business, the Commissioner has discretion to determine that such procedures did not clearly reflect Thor's income, which determination will be upheld unless it is plainly arbitrary (Pet. A-20–A-21, A-40). Not one of the cases relied upon supports this proposition. Two dealt with attempts by taxpayers to defer commission income,* and the others involved inventory procedures plainly inconsistent with generally accepted accounting principles.**

The three recent decisions cited in the preceding footnote are instructive. In each of them, the court found that the taxpayer's accounting procedures *did not conform* to generally accepted accounting principles, and therefore did not clearly reflect income. Because of this threshold finding, the Commissioner was entitled under § 446(b) to require a substitute procedure that did clearly reflect income. It is only this *substitute* procedure that the courts will not set aside unless it is "plainly arbitrary". See *Photo-Sonics, Inc.*, 42 T. C. at 933; *All-Steel Equipment Inc.*, 54 T. C. at 1761, and particularly *Bangor Punta Operations, Inc.* v. *United States,* 466 F. 2d at 935.

---

* *Brown* v. *Helvering,* 291 U. S. 193 (1934) (reserve against commission income for contingent cancellations of insurance policies); *Commissioner* v. *Hansen,* 360 U. S. 446 (1959) (deferral of commission on customer notes discounted by automobile dealers with finance companies).

** *Lucas* v. *Kansas City Structural Steel Co.*, 281 U. S. 264, 269 (1930) (improper "base stock" inventory method); *Bangor Punta Operations, Inc.* v. *United States,* 466 F. 2d 930, 934 (7th Cir. 1972); (improper and misapplied "practical capacity method" for allocating manufacturing overhead to inventory); *Photo-Sonics, Inc.*, 42 T. C. 926, 932 (1964), *aff'd,* 357 F. 2d 656 (9th Cir. 1966), *acq.* 1965-2 C. B. 6 (improper "prime cost method" for allocating manufacturing overhead to inventory); *All-Steel Equipment Inc.*, 54 T. C. 1749, 1753 (1970), *aff'd,* 467 F. 2d 1184 (7th Cir. 1972) (same issue as in *Photo-Sonics*).

4.

The Seventh Circuit takes the further position that Thor is not entitled to the presumptions that its income was clearly reflected because of "inferences" in the Tax Court's opinion that ". . . that the excess inventory Thor attempted to write off in 1964 had been accumulated 'over a period of several years' ", which in turn created the "implication" that Thor had not been consistent in its inventory valuation method (Pet. A-45).

This passage is perplexing. Although the Seventh Circuit's opinion acknowledges that the Tax Court did not make findings either on whether Thor had been consistent between 1964 and earlier years, or whether it had changed its method of accounting (Pet. A-41 n. 12, A-45), it does not mention that the Commissioner had the burden of proof on that issue pursuant to the Tax Court's pretrial order.*

The Seventh Circuit's reference to Thor's alleged inconsistency is substantively unsound. The requirement of consistency in tax accounting is directed to protecting the revenues —by prohibiting inconsistency that would result in income escaping tax altogether or in deductions being taken more than once. See generally the Congressional Reports on § 481 of the 1954 Code, H. R. Rep. No. 1337, 83d Cong., 2d Sess. A164-165 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 307 (1954); Staff of the Jt. Comm. on Internal Revenue Taxation, 84th Cong., 1st Sess., Summary of the New Provisions of the Internal Revenue Code of 1954 as Agreed to by the Conferees 69 (1955). But in this instance, any inconsistency by Thor *favored* the revenues. If Thor did not sufficiently write down excess inventory prior to 1964, it overstated

* See Thor's pretrial Motion (A14–A18) and the Order of June 14, 1972, granting it (A19). At the commencement of trial, the Tax Court further ruled that:

> ". . . any allegations of the method applied to the inventory as of December 31, 1963 being part of the new matter raised in the Answer, the burden of proof rests on the Respondent [the Commissioner] to come forward with the proof." (A34.)

its taxable income in the earlier years and paid too much tax. Because of this effect, the courts have given taxpayers considerable leeway in choosing the year for judgmental inventory writedowns such as for obsolete inventory. In fact, the usual contention of the Commissioner is that the taxpayer wrote off the inventory too soon. See, *e.g., C-O-Two Fire Equipment Co.* v. *Commissioner,* 219 F. 2d 57 (3rd Cir. 1955), *rev'g* 22 T. C. 124 (1954).

The Seventh Circuit's concern with Thor's inferred inconsistency leads to a radical result. A fundamental rule is that if a taxpayer claims too large a deduction or writedown for a particular year, he does not lose the entire deduction or writedown, but is entitled to the portion applicable to that year, and the balance in the year or years in which it properly belongs. The Seventh Circuit uses the consistency issue to deny Thor a writedown *in both 1964 and earlier years,* even though the $927,000 of excess inventory that existed at the end of 1964 must have arisen in one of those years. Instead, because Thor *may have been* "late" in writing down a portion of the excess, the Court would *further delay* the writedown until the inventory eventually is scrapped. This is both illogical and contrary to normal tax practice.

If the law requires the writedown to be made in the year when the inventory becomes excess, the solution is a remand to permit Thor to show when that occurred—a remedy to which Thor is entitled because of the pretrial order of the Tax Court in excluding this very evidence from the initial trial.* However, as will be shown at pp. 70-72 *infra,* the year in which inventory became excess is not relevant, because Thor is entitled according to existing authority to write down the excess inventory for tax purposes in the year when Thor first identifies it as such and writes it down on its books.

* See Thor's pretrial motion (A14–A18) and the Order of June 14, 1972, granting it (A-19).

D. Thor's Writedown of Excess Inventory Clearly Reflected Its Taxable Income

Even if the Seventh Circuit is correct that Thor is not entitled to the presumptions under both § 446 and § 471 that its income was correctly reflected because its inventory writedown procedures conformed to generally accepted accounting principles and constituted the best accounting practice, *and* if the Court is also right that the Commissioner's determination that Thor's procedures did not clearly reflect its income will be upheld unless it was plainly arbitrary, the conclusion is inescapable that Thor's procedures did clearly reflect its taxable income and that therefore the Commissioner's determination to the contrary was plainly arbitrary.

The Seventh Circuit does not question the Tax Court's conclusion that Thor's inventory procedures resulted in its financial income being correctly stated. Although both courts state the proposition, which Thor does not dispute, that taxable income is not *necessarily* the same as financial income, *cf. Frank Lyon Co.* v. *United States*, 46 U. S. L. W. 4313, 4317-18 (1978), Thor's taxable income for 1964 in fact was clearly stated.*

The meaning of the phrase "clearly reflects income" as used in § 446 and § 471 is not self-evident, but must be measured against some standard. Thor is aware of only four possible standards:

(i) the Regulations;

(ii) case law;

* In justifying the Commissioner's determination that Thor's method did not clearly reflect its income, the Court of Appeals states (Pet. A-46) that Thor's accounting experts ". . . did not testify that its 1964 income had been clearly reflected in its tax return . . .". They did not testify concerning "taxable income," because that was the ultimate issue of law before the Court. In fact, trial counsel for the Commissioner objected on that very ground to a question to an expert witness which he believed called for the witness' opinion whether Thor's "taxable income" was clearly reflected (A192–A193).

(iii) generally accepted accounting principles; and

(iv) the rules of the Securities and Exchange Commisison.

Both parties concede that the Regulations do not explicitly provide for the writedown of excess inventory.*

The cases discussed at pp. 38-43 *supra*, establish the rule that the writedown of inventory to net realizable value clearly reflects taxable income. This rule has been applied to work-in-process under fixed price contracts, *Space Controls, Inc.* v. *Commissioner*, 322 F. 2d 144 (5th Cir. 1963), *rev'g* 21 T. C. M. (CCH) 295, P-H TC Mem. Dec. 62-336 (1962), and *E. W. Bliss Co.* v. *United States*, 351 F. 2d 449 (6th Cir. 1965), *affirming on the opinion below* 224 F. Supp. 374 (N. D. Ohio 1963); obsolete inventory, *Lucker* v. *United States*, 53 F. 2d 418 (Ct. Cl. 1931); and excess inventory, *Fides Publishers Ass'n* v. *United States*, 263 F. Supp. 924 (N. D. Ind. 1967). The rationale of each of those decisions is that the writedown clearly reflected income because it was required by generally accepted accounting principles. The Commissioner has not cited any case to the contrary.

The standards of financial accounting requiring the writedown of excess inventory are clear and undisputed. Each expert testified that unless the excess inventory were written down, Thor's financial income would not have been correctly stated (pp. 12-13 *supra*). Indeed, the expert testimony established that if excess inventory were not written down until it was scrapped, Thor's income would be distorted both in the year when the inventory was determined to be excess and in the years when it eventually was scrapped.**

* Thor contends, pp. 64-70 *infra*, that an interpretation, consistent with the intention of § 471, of the language and purpose of either Regulation § 1.471-4(b) (market value) or § 1.471-2(c) (subnormal goods) permits the writedown of excess inventory.

** This is explained by the testimony of Mr. Frank T. Weston (A192—A193):

"Q. In the event that ending inventory were overstated because of the existence of excess quantities that were not

(Footnote continued on next page.)

That testimony corresponds to common sense. The Commissioner argues that to correctly state income, excess inventory should be carried until it is scrapped at historical cost which is $927,000 more than it is actually worth, and that the taxpayer somehow is distorting income by writing it down to its current net realizable value.

The rules of the Securities and Exchange Commission require the same results as do generally accepted accounting principles. While it is clear that the purposes of the S. E. C. are different from the responsibilities of the Commissioner in administering the income tax law, the issue here is whether Thor's inventory procedures "clearly reflected income". There is no reason why this concept should have a different meaning under § 446 and § 471 of the Code than it does for public financial statements, the accuracy of which is mandated by the Securities Act of 1933 and the Securities and Exchange Act of 1934.*

(Footnote continued from preceding page.)

valued downward to net realizable value, what would the effect of this be on the income for the current year and on the income for future periods?

"* * *

"A. A determination that at December 31 of a given year an inventory contains excess inventory which was, as you stipulate, not reduced to its net realizable value, would result, in fact, in an overstatement of income for that year.

"As to future years, presumably the inventory, if it were sold or scrapped at a price less than its carrying value, that loss would appear in some future period's income statement, and under generally accepted accounting principles, that result would be improper; that is, the charge, the revaluation of the inventory, the write down to net realizable value, should be made in the year during which the nature or [sic] the excess was determined or existed."

* In determining whether or not a taxpayer's accounting procedures clearly reflect its income, this Court has given weight to the accounting concepts of other agencies. See *Commissioner* v. *Idaho Power Co.*, 418 U. S. 1, 14-15 (1974), citing *Cincinnati, N. O. & T. P. Ry.* v. *United States*, 424 F. 2d 563 (Ct. Cl. 1970), which is discussed at pp. 47-48 *supra*. In the *Cincinnati* case the Court of Claims stated, *id.* at 570-71:

(Footnote continued on next page.)

In fulfilling the basic purpose of these Acts to protect investors by requiring the publication of accurate financial data, the S. E. C. long ago adopted the rule that financial statements prepared in accordance with accounting principles for which there is no "substantial authoritative support" are presumed to be "misleading or inaccurate". S. E. C. Accounting Series Release No. 4 (April 25, 1938), 11 Fed. Reg. 10913 (1938). This was reemphasized more recently by the S. E. C. in its Accounting Series Release No. 150 (December 20, 1973), 39 Fed. Reg. 1260 (1974):

> "In the exercise of its statutory authority with respect to the form and content of filings under the Acts, the Commission has the responsibility to assure that investors are provided with adequate information. A significant portion of the necessary information is provided by a set of basic financial statements (including the notes thereto) *which conform to generally accepted accounting principles.*" (Emphasis added.)*

(Footnote continued from preceding page.)

"Another fact which is entitled to appropriate probative value, but which is not conclusive, is the establishment by the ICC of the $500 minimum rule after careful consideration of the railroads' economic position. The testimony reveals that one of the prime considerations of the ICC in establishing the minimum rule was its effect on the ability of the railroads' financial statements to clearly reflect income. The ICC concluded that the imposition of the $500 minimum rule would not distort income. Although the accounting procedures required by the ICC are not binding upon the Commissioner of Internal Revenue. Old Colony R. R. v. Commissioner of Internal Revenue, 284 U. S. 552, 562, 52 S. Ct. 211, 76 L. Ed. 484 (1932), they are entitled to probative weight in the appropriate case. Northern Natural Gas Co. v. O'Malley, 277 F. 2d 128, 137-138 (8th Cir. 1960); Portland General Electric Co. v. United States, 189 F. Supp. 290, 298 (D. Ore. 1960), *aff'd.* 310 F. 2d 877 (9th Cir. 1962)."

* Release No. 150 defined as authoritative the "principles, standards and practices" promulgated by the Financial Accounting Standards Board (the FASB), the Accounting Research Bulletins of the AICPA Committee on Accounting Procedure and the Opinions of the AICPA Accounting Principles Board. See fn. at p. 48 *supra*.

If Thor had failed or refused to write down its excess inventory in preparing its income statements and balance sheets for 1964 and later years, the S. E. C. would have regarded them as inaccurate and misleading because they would have been based on an accounting practice for which there is no authoritative support.* Thor's problems with the S. E. C. would have been compounded because, as the experts testified (A114, A133, A158, A176 and A195), such financial statements would not have been certified (given an unqualified opinion) by Thor's independent public accountants as required by law.**

The overvaluation of inventory has been the subject of S. E. C. scrutiny. A recent example closely in point is *In the Matter of Eugene Testa and W. A. Stebbins*, A. S. R. No. 212, CCH Fed. Sec. L. Rep. ¶ 72,234 (1977), involving disciplinary action by the S. E. C. against the independent accountants for Photon, Inc., for failure to insist on an adequate, timely write-down of "slow moving and other obsolete inventory", which the S. E. C. characterized as evidencing "a marked disregard for generally accepted accounting principles and auditing standards as well as the Commission's Rules and Regulations" in violation of the antifraud and reporting requirements of the 1934 Act.

* The alleged overvaluation of Thor's assets, including inventory, in 1963 and earlier years led to an investigation by the S. E. C. in early 1965, which resulted in Thor amending its S. E. C. Form 10-K for 1964 to provide additional data (see Ex. S amending Ex. R).

** See § 13(a)(2), 15 U. S. C. § 78m(a)(2) (1976), and § 14(a), 15 U. S. C. § 78n(a) (1976), of the Securities Exchange Act of 1934; Rules 13a-1, 17 C. F. R. 240.13a-1 (1977), and 14a-3(b)(3), 17 C. F. R. 240.14a-3(b)(3) (1977), and Form 10-K thereunder; and Rule 2-02 of Regulation S-X (the S. E. C. regulation governing the form and content of financial statements filed under the Federal securities laws). The remedies available to the S. E. C. would include suspension of trading of Thor's securities, § 12(k) of the 1934 Act, 15 U. S. C. §78*l*(h) (1976), or injunctive proceedings, § 21(d), 15 U. S. C. § 78u(d) (1976). Thor would also be subject to express civil liabilities under § 18(a), 15 U. S. C. § 78r(a) (1976), and implied civil liabilities under Rule 10b-5, 17 C. F. R. 240.10b-5 (1977), and § 14(a), 15 U. S. C. § 78n(a) (1976). To the extent Thor's actions were deemed willful, it would be subject to criminal sanctions under § 32, 15 U. S. C. § 78ff (1976).

The S. E. C. specifically referred to a failure to write off inventory indicated as slow moving by a "usage test" performed by the accountants.*

* * *

Thus, the case law, generally accepted accounting principles as expounded by the uncontradicted testimony of the expert witnesses and by authoritative accounting publications, and the rules and practice of the S. E. C., uniformly point to the unequivocal conclusion that excess inventory must be written down to net realizable value in order to clearly reflect income. Against this array of authority, the courts below upheld the Commissioner's unexplained determination that Thor's inventory procedures somehow did not clearly reflect its taxable income.

E. The Requirement That Excess Inventory Be Valued at Cost Until It Is Scrapped Does Not Constitute the Best Accounting Practice or Clearly Reflect Income and Thus Is Contrary to the Requirements of Sections 446 and 471 of the Code

The Court of Appeals concluded that the Commissioner was entitled, "in exercising his broad discretion under § 471", to require excess inventory to be scrapped as a prerequisite to its writedown to net realizable value on the theory that, in contrast to financial accounting, tax accounting requires "realization" by closed transactions or identifiable events (Pet. A-46–A-47). None of the cases cited by the Seventh Circuit supports its thesis that inventory cannot be written down without

* For other recent S. E. C. proceedings based on overvaluation of inventory or other assets or contrary to generally accepted principles, see *In the Matter of Peat, Marwick, Mitchell & Co.*, A. S. R. No. 173, CCH Fed. Sec. L. Rep. ¶ 72,195 (1975) (improper failure to write off estimated production costs included in inventory under program cost method); *In the Matter of Seidman & Seidman*, A. S. R. No. 196, CCH Fed. Sec. L. Rep. ¶ 72,218 (1976) (inadequate reserves for losses on receivables); *In the Matter of Hertz, Herson & Co.*, A. S. R. No. 176, CCH Fed. Sec. L. Rep. ¶ 72,198 (1975) (inadequate bad debt reserve).

realization.* On the contrary, realization has never been applied to the writedown of inventory to the lower-of-cost-or-market. See discussion in *Space Controls, Inc.* v. *Commissioner, supra,* 322 F. 2d 144, 147-48 (5th Cir. 1963), citing *Sharp* v. *Commissioner,* 224 F. 2d 920, 924 (6th Cir. 1954) rejecting the Commissioner's contention that work-in-process cannot be written down because there was no realization of the loss by sale or scrapping. Similarly, since Article 1582 was added to Regulations 45 in 1922 by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922), the Regulations have permitted the writedown of subnormal goods without scrapping. This was recognized in A. R. R. 921, I-1 C. B. 126, 130-31 (1922), declared obsolete by Rev. Ruling 68-674, 1968-2 C. B. 609.

The issue is settled, however, by the express language of § 471, which requires that inventories must constitute a best accounting practice and must clearly reflect income. The scrapping test cannot be a best accounting practice because it violates generally accepted accounting principles, as the testimony of the expert accountants established. See discussion at pp. 55-56, *supra.* Based on the authority of the existing case law, generally accepted accounting principles, and the S. E. C. rules, the scrapping test also violates the other requirement of § 471 that the inventory practice clearly reflect income.

Implicit in the Seventh Circuit's opinion (Pet. A-46) and explicit in the Tax Court's,** is the belief that requiring excess

* *Brown* v. *Helvering,* 291 U. S. 193 (1934) (reserve against commission income for contingent cancellations of insurance policies); *United States* v. *American Can Co.,* 280 U. S. 412 (1930) (*write-up* of inventory from cost to a higher market value by the taxpayer); *American Can Co.* v. *Bowers,* 35 F. 2d 832 (2d Cir. 1929), *cert. denied,* 281 U. S. 736 (1930) (*write-up* of inventory from cost to a higher market value); *Lucas* v. *American Code Co.,* 280 U. S. 445 (1930) (reserve for contingent commission liability that was the subject of litigation).

** The Tax Court directly expressed its rationale by observing that the writedown of excess inventory ". . . based upon an otherwise unsupported opinion of the taxpayer as to its ultimate

(Footnote continued on next page.)

goods to be physically scrapped before they can be written off for tax purposes protects the revenues against taxpayer abuse by providing a more concrete standard than writeoff procedures. Thor submits that this concern is misplaced. Generally accepted accounting principles require that unsalable excess inventory be written down when it is identified as such. Thor's writedowns were directly based on the actual sales (or usage in production) of each item each year. This system automatically inhibits taxpayer manipulation, because it would be senseless for Thor to reduce sales (or production) in order to obtain larger writeoffs for excess inventory.

In contrast, under the scrapping standard, the taxpayer will have possession of excess quantities of goods which have already been written down for financial accounting purposes, as his independent accountants and the S. E. C. require, so he will have greater freedom to arbitrarily choose the year in which to scrap such goods to maximize tax benefits. Thus, the theory that the revenues will be protected by requiring scrapping is dubious at best.

F. Thor's Inventory Valuation Procedures Do Not Need to Be Explicitly Authorized by the Treasury Regulations in Order to Clearly Reflect Income

In deciding that Thor's procedures did not clearly reflect its taxable income, the Seventh Circuit analyzed the specific provisions of the Regulations necessarily on the tacit premise that unless the Regulations explicitly authorize a particular inventory procedure, it does not clearly reflect income (Pet. A-41).* That premise, unsupported by authority or reason, determines the

(Footnote continued from preceding page.)

salability . . . would, within some u known limits, permit the taxpayer to determine how much tax it wanted to pay for a given year" (Pet. A-26).

* The Tax Court was explicit in holding that in order to clearly reflect income, Thor's inventory procedures had to be authorized by the specific sections of the Regulations (Pet. A-23).

outcome, because the Commissioner, Thor and both lower courts agree that the Regulations do not explicitly provide for the writedown of excess inventory.

Neither of the lower courts cites any cases for the proposition that silence or ambiguity of the Regulations constitutes a prohibition, nor has Thor been able to find any. Rather, the cases establish the rule that an inventory procedure is permissible so long as it is neither *prohibited by* nor *inconsistent with* the Regulations. In *Monfort of Colorado, Inc.* v. *United States*, 561 F. 2d 190, 196 (10th Cir. 1977), discussed at p. 40 *supra*, the Tenth Circuit upheld the taxpayer's inventory method because, *inter alia*, it was not prohibited by the Regulations, stating:

> "We deem it significant to note that the IRS expert acknowledged that there was nothing in the regulations, to the best of his knowledge, which prohibited Monfort's tax treatment of hedging gains/losses. Under the circumstances, we will not hold that there is but one way and one way only for Monfort to value its ending inventories."

The Court stressed that its decision was ". . . in keeping with the regulatory mandates that valuations of inventory must necessarily be flexible in order to give effect to trade customs. . ." *ibid.*

The Tax Court has regularly applied the same rule. See *Fort Howard Paper Co.*, 49 T. C. 275, 285-86 (1967), distinguishing *Photo-Sonics, Inc.*, 42 T. C. 926 (1964), *aff'd*, 357 F. 2d 656 (9th Cir. 1966), *acq*. 1965-2 C. B. 6. In *Hutzler Brothers Co.*, 8 T. C. 14, 27-28 (1947), the Commissioner's contention that the LIFO inventory method could not be combined with the retail sales method in the absence of authorization by the Regulations was rejected by the Court:

> "All of the regulations are as consistent with petitioner's position as they are with that of respondent. . . . It is simpler and more rewarding to seek the meaning of the statute itself than of ambiguous and largely irrelevant administrative interpretations." (Footnote omitted.)

Quite apart from this authority, the failure of the Regulations to explicitly authorize a particular inventory procedure cannot mean that that procedure *does not* clearly reflect income, for this would nullify the presumption of § 1.471-2(b) of the Regulations, in the Regulations since 1920, that an inventory procedure which conforms to the "best accounting practice" ordinarily *does* clearly reflect income. As has been shown, that long-continued administrative interpretation in the Regulations has Congressional approval. See discussion at pp. 35-38 *supra*.

It is also clear that until the amendments of 1973, the Regulations never purported to require that an accounting procedure had to be "in accord" with the specific provisions of the Regulations. See footnote at p. 32 *supra*.

The Commissioner's actual practice since 1918 contradicts the assertion that inventory procedures must be explicitly authorized by the Regulations to clearly reflect income. Until § 1.471-11 was added in 1973, the Regulations contained only primitive guidance to manufacturers for determining cost—notwithstanding that cost is the starting point of inventory valuation, conceptually its most important element. Prior to that year, the Regulations did not specify how indirect manufacturing overhead was to be allocated to inventory (now in § 1.471-11(c)(2)), and did not authorize the use of either a standard cost method or a manufacturing burden rate system (now in § 1.471-11(d)). Yet Thor has found no case in which the Commissioner took the position that a manufacturer was not entitled to allocate manufacturing overhead to inventory by any of these cost accounting methods because they were not explicitly authorized by the Regulations.

To treat the silence of the Regulations as prohibitory in the instant case would be patently unfair because the Treasury has been aware, at least since the early 1960's, that the Regulations do not contain any explicit guidance for valuing excess inventory. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, 23 N. Y. U. Institute

on Federal Taxation 839, 850 (1965). The Regulations have yet to be amended to cure this defect, notwithstanding repeated criticism for the omission. See *e.g.* the Statement by the AICPA Division of Federal Taxation, submitted in 1972 at the request of the Internal Revenue Service on the then pending amendments to the inventory Regulations under § 471 (Ex. 29, A151, A223).

G. Thor's Inventory Valuation Procedures Are Authorized by a Construction of the Treasury Regulations That Conforms to the Intention of Section 471 of the Code

Even though Thor is entitled, for the reasons already given, to write down its excess inventory to net realizable value regardless whether detailed provisions of the Regulations expressly authorize it, in fact two provisions of the Regulations, construed to effect the basic intention of § 471, do authorize such a writedown.

These are the Regulations governing the writedown of normal goods from cost to market (§ 1.471-4(b)) and permitting the writedown of subnormal goods (§ 1.471-2(c)). Neither explicitly covers excess inventory, but both embody, albeit imperfectly, the generally accepted accounting principle that goods in inventory should not be valued at more than net realizable value. See Statement 6, Chapter 4, of AICPA Accounting Research Bulletin No. 43, quoted at p. 50, *supra*.

1.

Treasury Regulation § 1.471-4(b) provides for a writedown of normal goods to net realizable value when *market conditions are not normal:*

> "*Where no open market exists* or where quotations are nominal, due to inactive market conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory *as may be available*. . . . Where the taxpayer in the regular course of business has

> offered for sale such merchandise at prices lower than the current price as above defined [in § 1.471.4(a)], the inventory may be valued at such prices less direct cost of disposition. . . ." (Emphasis added.)

Although this does not refer to the valuation of excess inventory, it does evince an intention to permit the writedown of normal goods in an inventory to their net realizable value when market supply and demand conditions make impractical the usual rules for determining "fair market price". The testimony of Thor's president (Pet. A-14, A61–A62) and of the expert witnesses (*e.g.*, A129–A130) establishes that normal market conditions do not exist for parts and accessories which are purchased only by a limited number of owners of a particular tool who need to replace a broken or worn part.

The Court of Appeals, citing inapposite cases,* held that this Regulation was not applicable because Thor intentionally and regularly produced excess quantities of parts, so the existence of the excess was not an "exceptional circumstance permitting their market valuation to be set at other than their replacement cost" (Pet. A-43). Nothing in the Regulation refers even inferentially to "exceptional circumstances" or to why goods are produced. All manufactured products are intentionally produced. Even though parts are deliberately manufactured in liberal quantities to forestall uneconomical production reruns, the manufacturer does not intend them to become excess any more than a retailer intends merchandise he purchases to become obsolete, even though he knows that a portion eventually will.

This Regulation exclusively and realistically focuses on the *market conditions* affecting the salability of inventory, and in

* *Knapp King-Size Corp.* v. *United States*, 527 F. 2d 1392, 1399-1400 (Ct. Cl. 1975) ("fair market value" is based upon reproduction cost, not upon *higher* resale value); *D. Loveman & Son Export Corp.*, 34 T. C. 776 (1960), *aff'd on opinion below*, 296 F. 2d 732 (6th Cir. 1961), *cert. denied*, 369 U. S. 860 (1962) (when net realizable value is in *excess* of cost, "market" is actual replacement cost and not lower "published prices" unavailable to the taxpayer).

doing so requires that "... the taxpayer must use such evidence of fair market price at the date or dates nearest the inventory *as may be available* . . ." (Emphasis added). In construing similar language under a predecessor to this Regulation,* the District Court in *E. W. Bliss Co.* v. *United States, supra,* 224 F. Supp. 374 (N. D. Ohio 1963), *aff'd on opinion below,* 351 F. 2d 449 (6th Cir. 1965), allowed the taxpayer to write down work-in-process without offering the product for sale, observing that ". . . there can be no open market for a partially finished press built to specifications of a particular purchaser. . . ." 224 F. Supp. at 379. From this, it concluded that in valuing the presses the taxpayer could "use such evidence of fair market price at the date or dates nearest the inventory as may be available." *Ibid.* There similarly is no open market in the usual sense for Thor's replacement parts, each of which is built to the specifications for a particular tool and is useful only to replace a part of such tool.

What Thor did fits both the intention and language of the Regulation. By reasonable procedures, it estimated what quantity of each inventory item was not salable. It then valued that unsalable quantity at net realizable (scrap) value which was its "fair market price" within the meaning of the Regulation.

2.

Section 1.471-2(c), consistent with generally accepted accounting principles, authorizes the writedown of *subnormal* goods in inventory to net realizable value without requiring them to be scrapped:

> "Any goods in an inventory *which are unsalable at normal prices* or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, *or other similar causes* . . . should be valued at bona fide selling prices less direct cost of disposition . . . or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a

* Treas. Reg. 111, § 29.22(c)-4.

> reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date." (Emphasis added.)*

Both lower court opinions ignore the broad intention expressed in the opening language, which specifies "*any* goods in an inventory which are unsalable at normal prices" (emphasis added). This language is followed by a list of examples that does not connote any restrictiveness. Read together the opening language and the examples are directed towards dislocations or insufficiency of market demand, which, as the testimony of Thor's president and the expert witnesses demonstrates (see p. 65, *supra*), surely appertains to parts that are useful only to an owner of a tool who needs a particular replacement part.

Instead of addressing the broad purpose of the Regulation, the Seventh Circuit restrictively concluded that the term "other similar causes" in the Regulation does not apply to excess goods because they are "not distinguishable from other units of inventory" (Pet. A-42). The opinion does not explain the relevance of such a requirement, nor do the cases cited support its conclusion.** This theory seems to have originated with the Tax Court's position that subnormal grounds must have a distinguishing physical defect (Pet. A-27), but that concept is not consistent with the examples listed. Although the Regulation lists types of subnormal goods possessing physical defects, it also includes "odd or broken lots" which do not have any special physical characteristics distinguishing them from non-defective goods in normal lots, but which must be sold at lower prices because the

* This language first appeared in Regulations 45, Art. 1582, added by T. D. 3296 (approved March 3, 1922), I-1 C. B. 40 (1922).

** *Lucas* v. *Kansas City Structural Steel Co., supra,* 281 U. S. 264, 270-71 (1930) (involving the improper "base stock method" of valuing inventory); and *Cleveland Automobile Co.* v. *United States,* 70 F. 2d 365, 368-69 (6th Cir.), *cert. denied,* 293 U. S. 563 (1934) (involving an arbitrary writedown by a manufacturer of new automobiles many of which were later sold at full list price).

quantity offered or the mix of goods is not customary in the marketplace. Excess quantities of spare parts are analogous to odd or broken lots, because they represent a quantity unsuitable for actual market conditions, and therefore have lost a portion of their market value. In short, the phrase "other similar causes" manifests, under the doctrine of *ejusdem generis,* an intention of the Treasury that situations similar to (though not exactly the same as) the examples given are to be similarly treated.

The Seventh Circuit further narrowly construed the Regulation by literally reading the last sentence of it to require Thor to offer excess finished tools, parts and accessories at scrap value prices within 30 days of the year-end valuation date as a prerequisite to writing them down.* This literal application of § 1.471-2(c) to worthless goods has not been required by any court to which the issue has been presented. In *Queen City Woodworks & Lumber Co.* v. *Crooks,* 7 F. Supp. 684, 685 (S. D. Mo. 1934), the Court held that it was unrealistic for the Commissioner to require worthless obsolete goods to be offered for sale, perhaps tacitly according to the ancient maxim that the law does not require a useless act. In *Fides Publishers Ass'n* v. *United States,* 263 F. Supp. 924, 936 (N. D. Ind. 1967), discussed at pp. 42-43 *supra,* neither the Commissioner nor the Court invoked the 30-day rule incident to permitting current titles held by a publisher in excess of two years supply to be written off. See also *E. W. Bliss Co.,* discussed p. 66, *supra.*

The very nature of excess stock precludes literal application of the 30-day rule. Excess stock by definition exists where a portion of an item in inventory is salable at normal prices, while remaining quantities of that item cannot be sold at any price except as scrap. To meet the 30-day rule, the taxpayer would have to offer to sell the excess quantities at scrap value, while simultaneously attempting to merchandise the salable quantities at normal prices.

* The 30-day rule does not apply to raw materials and work-in-process.

3.

Notwithstanding that in this case the Commissioner seeks a narrow construction of both the market value (§ 1.471-4) and the subnormal goods (§ 1.471-2(c)) Regulations, he recently acknowledged that writedowns for excess stock *are authorized* by both of those Regulations. Revenue Procedure 76-28, 1976-2 C. B. 645, 646, governing the changeover by taxpayers to the LIFO method from other inventory methods, provides in § 4.02:

> "Solely for purposes of this Revenue Procedure, so-called 'excess stock' write-downs and percentage write-downs applied to a class or type of goods will be considered as coming within the write-down restoration rules contained herein pertaining to section 1.471-2 of the regulations."

This final version of the Revenue Procedure refers to the subnormal goods provisions (§ 1.471-2(c)); an earlier version referred instead to the market value Regulations (§ 1.471-4).*

* * *

Both lower courts construed the market value and the subnormal goods Regulations narrowly. In doing so, they not only did violence to their plain language, but ignored the purposes of the Regulations, and accordingly departed from the intention

* The earlier version stated, I. R. B. 1976-30, p. 19:

> "For purposes of this Revenue Procedure so-called 'excess stock' write-downs and percentage write-downs applied to a class or type of goods, to the extent they are not otherwise a write-down pursuant to section 1.471-4 of the regulations, will be considered as coming within the write-down restoration rules contained herein."

This change came from Announcement 76-115, I. R. B. 1976-36, p. 16, in which the Commissioner stated:

> "Although there may be situations where excess stock and percentage write-downs should be treated as market write-downs for purposes of section 1.471-4, the Service does not intend this treatment for purposes of Rev. Proc. 76-28. *For purposes other than Rev. Proc. 76-28, the Service will not be precluded from treating excess stock* and percentage *write-downs as market adjustments under section 1.471-4.*" (Emphasis added.)

of § 471 that inventories shall conform to the best accounting practice. This construction, indifferent to the realities of the marketplace, is puzzling in light of the fact that it is the Treasury which failed to amend the Regulations to provide rules for the valuation of excess inventory even though it has been aware of the problem since at least the early 1960's. See pp. 63-64, *supra.*

H. The Writedown of Excess Inventory Is Properly Chargeable Against Taxable Income in the Year When the Excess Is First Identified

Throughout this case, the Commissioner has argued that Thor is not entitled to a writedown for some $927,000 of inventory identified as excess and written down on Thor's books in 1964, but must wait to a later year when that excess is actually scrapped; the Commissioner alternatively has contended that, if inventory is to be written down before it is scrapped, any portion of the excess that developed prior to 1964 should have been written down in such earlier year or years. Because of the Tax Court's pretrial order precluding evidence of when the excess arose (A19), there is nothing in the record as to whether all the $927,000 of excess inventory written down in 1964 actually became excess in that year or whether a portion arose in earlier years.

The Commissioner's alternative position is entirely theoretical. A remand to the Tax Court to determine whether some inventory became excess in an earlier year will have *no* effect on Thor's total income tax liability.* If some of the excess is found to have arisen prior to 1964, Thor will be entitled to the benefit of additional interest on the tax it will have overpaid in the earlier years by failing to take the writedown.

* In the event of a remand, § 6214(b) authorizes the Tax Court to examine the facts relating to 1961 through 1963 to determine which items became excess in each of the years 1961-1963 and adjust Thor's tax liability accordingly. If, as is unlikely, any inventory became excess in 1960 or prior years, the mitigation provision of

(Footnote continued on next page.)

Analogous authority suggests that the proper year for writing down excess inventory is the year in which it is identified as such. This is consistent with the language of the market value Regulation, § 1.471-4(b), quoted at pp. 64-65 *supra,* which is not couched in mandatory language. *Cf. C-O-Two Fire Equipment Co.* v. *Commissioner,* 219 F. 2d 57, 59 (3rd Cir. 1955), *rev'g* 22 T. C. 124 (1954) (obsolete goods).

Because identification of items as excess depends upon the interaction between supply and demand and on collateral factors such as technological innovations, changes in marketing strategies, and the like, such identification as excess necessarily involves considerable subjective judgment of management. It would be highly impractical to require taxpayers to amend earlier years' tax returns because excess inventory identified in a later year actually may have developed in the earlier year.

This approach is fair to the revenues because any delay by the taxpayer in recognizing the existence of excess inventory postpones the tax reduction caused by such writedown.

If, contrary to the foregoing, this Court holds that Thor is entitled to write down excess inventory only in the year when the items became excess, this case should be remanded to the Tax Court for the introduction of appropriate evidence. Such a remand is required to preserve Thor's right to introduce such evidence established by the Tax Court's pretrial order of June 14, 1972 (A19), and reiterated by the Court at the end of trial (A207–A208).

(Footnote continued from preceding page.)

§§ 1311 *et seq.* would entitle Thor to a refund for any overpayment of taxes in those years resulting from Thor's failure to write down excess inventory at that time. (It should be noted that although the Tax Court has jurisdiction under § 6214(b), jurisdiction under §§ 1311 *et seq.* is limited to the Federal District Courts and the Court of Claims.)

Thus, between § 6214(b) and §§ 1311 *et seq.*, Thor is entitled to a tax reduction for $927,000 of excess inventory writedowns on December 31, 1964, regardless when (prior to that date) the inventory actually became excess.

II.

THE COURT OF APPEALS ERRED IN HOLDING THAT THE COMMISSIONER HAS DISCRETION TO IGNORE CURRENT FACTS CONCERNING THE COLLECTIBILITY OF A TAXPAYER'S ACCOUNTS BY MECHANICALLY LIMITING THE TAXPAYER'S RESERVE FOR BAD DEBTS TO A SIX-YEAR AVERAGE OF ITS BAD DEBT CHARGEOFFS

The Tax Court found as a fact (Pet. A-16) and the Court of Appeals reiterated (Pet. A-47) that at the close of 1965 the collectibility of each of Thor's accounts receivable over $100 was evaluated by Thor personnel most familiar with the particular account, and that these evaluations were reviewed sequentially by three levels of management. See pp. 15-16 *supra*. These careful and detailed estimates showed that a total reserve of $228,948 was necessary at the end of 1965, requiring an addition of $135,150 to the then existing balance of Thor's bad debt reserve. Of the total reserve required, some $184,000 was attributable to several long-overdue accounts that Thor judged to be wholly uncollectible. There is no suggestion in either opinion below that Thor's evaluation of these accounts was inaccurate in any way. The Commissioner does not contend that it was.

Notwithstanding Thor's exacting procedures, the Commissioner determined that a "reasonable" addition to the reserve was limited by a mechanical formula, first used in *Black Motor Co.*, 41 B. T. A. 300 (1940), *aff'd on other issues*, 125 F. 2d 977 (6th Cir. 1942), *acq*. 1944 C. B. 3. The Commissioner divided Thor's total writeoff of receivables during 1965 and the five preceding years by the total of its year-end receivables for those six years. The resulting percentage of 3.128% was applied to Thor's 1965 year-end balance of receivables from customers to calculate a maximum allowable reserve of $154,157. This formula permitted Thor to increase its existing reserve by only $61,359.

The Commissioner's insistence upon application of the *Black Motor* formula in this case is inconsistent both with § 166(c) of the Code, which entitles the taxpayer to a "reasonable" addition to its reserve, and with the express language of Treasury Regulation § 1.166-4(b)(1), which requires that a bad debt reserve ". . . shall be determined in the light of the facts existing at the close of the taxable year. . . ."

Indeed, the decisions below go further than any other reported case in conferring upon the Commissioner *carte blanche* authority to impose the *Black Motor* chargeoff formula without regard to the taxpayer's current data on the collectibility of its receivables. The *Black Motor* formula was never intended to have such sweeping use.

A. Section 166(c) of the Code Authorizes a Deduction for a "Reasonable" Addition to a Reserve for Bad Debts, Which the Treasury Regulation Requires To Be Based on Current Facts

Section 166(c) of the Code provides that a taxpayer, like Thor, who has properly elected the reserve method:

> ". . . shall be allowed (in the *discretion* of the Secretary or his delegate) a deduction for a *reasonable* addition to a reserve for bad debts." (Emphasis added.)

The statute sets forth two distinct requirements: (i) the Commissioner must exercise discretion and (ii) the addition to the reserve must be reasonable.

Treasury Regulation § 1.166-4(b)(1) emphasizes the primacy of current facts in the determination of what constitutes a reasonable addition to a reserve:

> "What constitutes a reasonable addition to a reserve for bad debts *shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition.* The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity." (Emphasis added.)

The Regulation does not mention bad debt chargeoffs of the taxpayer as a factor to be considered.

B. The Black Motor Formula Was Not Intended To Be a Per Se Limitation on a Taxpayer's Bad Debt Reserve, and Should Not Be Used as Such Because It Is Inherently Arbitrary

In the *Black Motor* case, the taxpayer did not introduce any evidence showing how it had computed the addition to its bad debt reserve for the year at issue. Due to this lack of evidence, the Board of Tax Appeals sustained the Commissioner's calculation of the reserve based on a six-year average of the taxpayer's bad debt chargeoffs. Under those circumstances, the use of the formula was reasonable.

It is clear from its opinion that the Board did not intend the formula to be used as a *per se* rule, or even as a customary standard, of what is a reasonable addition to a bad debt reserve. It declared, 41 B. T. A. at 304:

> "The test, however, is whether the amount ultimately determined, regardless of formula, constitutes a reasonable addition to petitioner's reserve. *What constitutes a reasonable addition will depend upon the facts and circumstances of the business* engaged in with relation to general business conditions. A method or formula that produces a reasonable addition to a bad debt reserve in one year, or a series of years, may be entirely out of tune with the circumstances of the year involved." (Emphasis added.)

As recently as 1976, the Commissioner recognized that the *Black Motor* formula cannot be applied on an automatic basis. In Revenue Ruling 76-362, 1976-2 C. B. 45, 46, the Commissioner announced:

> ". . . [I]f the taxpayer can demonstrate that an amount greater than the amount determined under the *Black Motor* formula is reasonable, in light of the facts existing at the close of the taxable year, the taxpayer may compute the greater amount to be added to the reserve for bad debts."

In reaching that conclusion, the Ruling cited with approval the Tax Court's decision in *Westchester Development Co.*, 63 T. C. 198 (1974), *acq.*, 1975-2 C. B. 2, discussed at p. 79, *infra.*

This limitation on the use of the *Black Motor* formula is well founded because the formula is inherently arbitrary. It has built-in lags if the taxpayer's sales are increasing, if his bad debt chargeoffs are rising, if the average age of his receivables are lengthening, but most importantly, if he delays making charge-offs. The inaccuracy of the formula is leveraged if the year-end balance of the taxpayer's accounts receivable is larger or smaller than normal. These defects are thoroughly analyzed in Whitman, Gilbert & Picotte, *The Black Motor bad debt formula: Why it doesn't work and how to adjust it,* 35 J. of Taxation 366 (1971).

The primary objection to the formula is that it cannot take into account special circumstances which entitle a taxpayer to a larger addition than his average bad debt experience would permit.* If a single customer of Thor went bankrupt owing it $184,000, there would be no question that Thor should be entitled to a larger than average addition to its bad debt reserve for the year. Yet that is inherently no different than the fact that at the end of 1965 Thor had several customers owing it $184,000 from whom it could not collect.

The formula is also subject to taxpayer manipulation. If Thor had been attempting to minimize its taxes in 1965, it would have charged off the $184,000 of hardcore uncollectibles. This would have increased its loss ratio to 3.763%. Applied to Thor's receivables at the end of that year according to the formula, it would have entitled Thor to a "reasonable" *addition* to its reserve of $269,723 as compared with the $136,150 addition it actually sought to deduct. Thor could have justified the $136,150 addition under the formula by writing off about $65,000 of the uncollectible accounts.**

---

* This is why the accounting experts testified that the *Black Motor* formula does not conform to generally accepted accounting principles. See pp. 16-17 *supra.* The S. E. C. is similarly concerned with inadequate bad debt reserves. See fn. at p. 59.

** Such chargeoffs do not require a "forgiveness" of the debt.

It becomes apparent that the *Black Motor* formula, which *directly* depends on the amount of debts charged off by the taxpayer, is contrary to the clear Congressional intention expressed in the companion subsection 166(a) governing the deductibility of wholly worthless bad debts by a taxpayer who has not elected the reserve method. After years of controversy, § 166(a) was amended by the Revenue Act of 1942 to permit a taxpayer to deduct a wholly worthless bad debt in the year it became worthless, regardless whether or not it had been charged off on the taxpayer's books.*

For these reasons, the use of the *Black Motor* formula should not be extended beyond the situation where it first arose—*i.e.*, where the taxpayer cannot demonstrate how he calculated his reserve for bad debts or where his calculation is not sound. Where, as in this case, the taxpayer demonstrates a careful and thoughtful review of the accounts by personnel familiar with them, and subsequent review by three additional levels of company management, *the accuracy of which is not questioned by the Commissioner*, this Court should not endorse the Commissioner's rigid insistence upon a questionable, if not arbitrary, formula.

C. The Commissioner Must, in Exercising His Discretion Under § 166(c), Take Into Account Current Data on Collectibility of the Taxpayer's Receivables

Although § 166(c) has been construed to give the Commissioner discretion in determining what is a reasonable addition to a bad debt reserve, *e.g., Malone & Hyde, Inc.* v. *United States*, 568 F. 2d 474, 477 (6th Cir. 1978); *Patterson* v. *Pizitz,*

* See § 23(k)(1) of the 1939 Code, the predecessor to § 166(a), as amended by § 124 of the Revenue Act of 1942, 56 Stat. 798, 820-21 (1942). See H. R. Rep. No. 2333, 77th Cong., 2d Sess. 76 (1942); S. Rep. No. 1631, 77th Cong., 2d Sess. 89-90 (1942); *Revenue Act of 1942: Hearings Before the Comm. on Finance, United States Senate, on H. R. 7378*, 77th Cong., 2d Sess. 51, 692-93, 1612-13 (1942).

Inc., 353 F. 2d 267, 268-70 (5th Cir. 1965), *cert. denied*, 383 U. S. 910 (1966), the courts have not permitted the Commissioner to entirely ignore current facts and circumstances in favor of the taxpayer's chargeoff history, but consistently have found such an approach to be an abuse of discretion.

In *Calavo, Inc.* v. *Commissioner*, 304 F. 2d 650 (9th Cir. 1962), *reversing and remanding* 19 T. C. M. (CCH) 1359, P-H TC Mem. Dec. 60-1507 (1960), the Ninth Circuit held that the Commissioner had abused his discretion by failing to consider specific data on the probable uncollectibility of one of the taxpayer's accounts due from a debtor in financial difficulties. The Court of Appeals stated, *id.* at 654:

> "It is clear that debts may not be charged off against the reserve until they have become worthless. It does not follow, however, that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to reserve. Since the reserve normally is dealing with unknown factors bearing upon unidentifiable accounts, its reasonable extent is ordinarily calculated by resort to past experience with such accounts in the composite. But the fact that experience is the guide in dealing with unknown factors and unidentifiable accounts *should not require us to reject the more accurate guidance of known factors bearing upon identifiable accounts when such information is available. The extent of a reasonable reserve should depend upon an adjustment between known circumstances and experience.*" (Emphasis added.)

In its remand, the Ninth Circuit directed the Tax Court to resubmit the question to the Commissioner ". . . for an exercise of his discretion free from his erroneous conception that the circumstances particularly affecting a specific debt must be completely disregarded in determining the reasonableness of additions to [the] reserve." *Id.* at 655.*

* The Ninth Circuit later distinguished *Calavo* in *United States* v. *Haskel Engineering & Supply Co.*, 380 F. 2d 786 (9th Cir. 1967),

(Footnote continued on next page.)

Calavo was followed by the Sixth Circuit in *Travis* v. *Commissioner*, 406 F. 2d 987, 991-92 (6th Cir. 1969). There the Commissioner refused to permit an addition to a bad debt reserve for uncollectible receivables arising from a dance studio's renegotiation of contracts with its customers. The Sixth Circuit held that this failure to consider current facts relating to the collectibility of the accounts made the Commissioner's calculation of the reserve "unrealistic and 'clearly erroneous.'" *Id.* at 991.

Rhode Island Hospital Trust Co. v. *Commissioner*, 29 F. 2d 339 (1st Cir. 1928), *rev'g* 8 B. T. A. 555 (1927), was decided prior to *Black Motor,* but it involved a similar failure by the Commissioner to exercise his discretion in light of current facts. The Commissioner disallowed additions to the taxpayer's reserve for bad debts totalling $287,500, of which $200,000 was based on the taxpayer's appraisal of current deteriorating economic conditions in New England where it operated its small loan business, and of which another $87,500 was attributable to notes of a debtor in receivership. The First Circuit remanded the case for a determination, in light of the particular facts, of the amount which should be added to the taxpayer's reserve, declaring, 29 F. 2d at 341:

> ". . . if the Commissioner and the Board of Tax Appeals exercised their discretion, on legal and reasonable grounds, this court could not substitute its discretionary judgment for that of the tax authorities. But if there was failure really to exercise discretion, or error of law in its exercise, then the court must grant relief."

In each of these decisions by the First, Sixth and Ninth Circuits, the Commissioner was found to have abused his discre-

(Footnote continued from preceding page.)
rev'g 66-1 U. S. Tax Cas. 85,499, 17 Am. Fed. Tax R. 2d 861 (S. D. Cal. 1966), seemingly on the ground that the Commissioner had reviewed the factors urged by the taxpayer and had properly elected to ignore them.

tion because he failed to consider current data on collectibility.* This is exactly the situation in the instant case, where the rigid use of the six-year chargeoff average ignores the taxpayer's careful determination that some $184,000 of long-overdue accounts were uncollectible, representing 80.4% of the entire reserve required at the end of 1965 (Ex. 18, A38, A222).

In *Westchester Development Co.*, 63 T. C. 198 (1974), *acq.*, 1975-2 C. B. 2, in which the Commissioner acquiesced and cited as authority in Revenue Ruling 76-362, *supra*, pp. 74-75, the Tax Court found that application of the *Black Motor* formula was an abuse of discretion where the six-year period was unrepresentative of the taxpayer's current situation, stating 63 T. C. at 212:

> "The formula used by respondent will produce a satisfactory result where a *relative consistency* has emerged *in the pattern of the taxpayer's bad debt losses.* Reason compels us to conclude that petitioner's fiscal years ended February 29, 1968, and February 28, 1969, would prove *a wholly unrepresentative period in the history of petitioner's bad debt losses;* for petitioner's debtors were for the most part thinly capitalized corporations, the principal source of whose working capital was construction loans. Under the circumstances obtaining in this instance, we find respondent's attempt to apply the formula hereinabove described to have been wholly unwarranted and an abuse of discretion." (Emphasis added.)

* To the same effect see *Norfolk Industrial Loan Ass'n* v. *United States,* 70-2 U. S. Tax Cas. 84,251, 84,257, 26 Am. Fed. Tax R.2d 70-5296, 70-5303 (E. D. Va. 1970). The Commissioner was found to have abused his discretion by refusing to take into account the fact that many of the plaintiff's loans were delinquent more than 90 days. In that case, the reserve claimed by the taxpayer represented 75% of its accounts 90 days past due; Thor's entire reserve represented less than 40% of its accounts more than 90 days past due (Ex. 18, A38, A222).

See also *Richardson* v. *United States,* 330 F. Supp. 102 (S. D. Tex. 1971); *Gold-Pak Meat Co., Inc.,* 30 T. C. M.(CCH) 337, P-H TC Mem. Dec. 71-357 (1971); *Duffey* v. *Lethert,* 63-1 U. S. Tax Cas. 88,182, 11 Am. Fed. Tax R.2d 1317 (D. Minn. 1963).

During the period 1960 through 1963, Thor's accounts receivable increased 26.1%, while sales rose only 8.5%. The chargeoffs by prior management during this same period dropped from 10% of Thor's receivables balance in 1960 to 0.8% in 1963 (Ex. 6-F). These trends are consistent with the undisputed evidence that Thor's management prior to 1964 had overvalued its assets (A50), and vividly shows how "wholly unrepresentative" was the historical data upon which the *Black Motor* formula is based in this case.

* * *

The Commissioner's use of the *Black Motor* formula in the instant case thus did not comply with the statutory requirement that he exercise his discretion to determine a "reasonable" addition to the taxpayer's bad debt reserve, because that formula ignored all current data on the collectibility of Thor's accounts, contrary to the requirement of the Treasury Regulations.

CONCLUSION

The fact that the Court of Appeals sustained the action of the Commissioner on both the inventory and bad debt issues not only produces incongruous results, but also highlights the necessity for this Court to make clear that the Commissioner does not have unfettered discretion to reject generally accepted accounting principles in administering the Code.

In valuing its excess inventory, Thor primarily utilized a formula based directly on historical sales data to objectively value 44,000 different items of inventory which could not practically be valued on an item-by-item basis. Notwithstanding the fact that Thor's procedures were in accordance with generally accepted accounting principles and constituted the best accounting practice, the Court of Appeals held that the Commissioner did not abuse his discretion in determining *without explanation* that those procedures did not clearly reflect Thor's income. Conversely, although Thor evaluated its accounts receivable by an item-by-item analysis, the Court of Appeals held that the Commissioner did not abuse his discretion by requiring *without explanation* Thor to value these accounts by a formula based on Thor's 6-year history of bad debt chargeoffs.

In effect, the Seventh Circuit accorded the Commissioner virtually unlimited discretion to disregard generally accepted accounting principles as to Thor's inventory and bad debt valuation procedures. Nothing in the statutory language or its history suggests that Congress, when it enacted sections 446, 471 and 166(c) of the Code, intended the Commissioner to have such broad authority on an *ad hoc* basis, independent of any objective standards, to impose his own view of "proper" accounting on taxpayers whose accounting procedures unequivocally comply

with generally accepted accounting principles, are the best accounting practice in their trade or business, and are not inconsistent with the applicable Treasury Regulations.

Thor acknowledges that the objectives of these sections of the Code require a discretion in the Commissioner to deal with highly variegated factual situations, changing accounting practices, and potential overreaching by a small percentage of taxpayers. It submits, however, that in this instance the discretion has been extended to such extent that there are no objective standard at all. This is alien to a Government dedicated to laws rather than to decrees. It is unsound policy in that it undermines taxpayer morale in a self-assessment system that requires a deeply rooted feeling by taxpayers that they are being treated reasonably and fairly.

* * *

For the foregoing reasons, Thor respectfully requests this Court to reverse the judgment of the Court of Appeals on both the inventory and bad debt issues.

Respectfully submitted,

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner, Thor Power Tool Co.,

Of Counsel:
MAYER, BROWN & PLATT.

No. 77-920

In the Supreme Court of the United States

OCTOBER TERM, 1978

THOR POWER TOOL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

WADE H. McCREE, Jr.,
Solicitor General,

M. CARR FERGUSON,
Assistant Attorney General,

STUART A. SMITH,
Assistant to the Solicitor General,

ANN BELANGER DURNEY,
WILLIAM A. WHITLEDGE,
Attorneys.
Department of Justice,
Washington, D.C. 20530.

INDEX

271-212—78——1

CITATIONS

Cases:

Cases—Continued

Cases—Continued

Cases—Continued

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-920

THOR POWER TOOL COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (Pet. App. A-6 to A-32) are reported at 64 T.C. 154. The opinion of the court of appeals (Pet. App. A-34 to A-48) is reported at 563 F.2d 861.

JURISDICTION

The judgment of the court of appeals was entered on September 29, 1977 (Pet. App. A-33). The petition for a writ of certiorari was filed on December 27, 1977, and was granted on March 6, 1978 (A. 267).

271-212—78——2

The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Petitioner reduced its closing inventory to an estimated "net realizable value," thereby increasing its cost of goods sold and reducing its taxable income by the amount of the inventory "write-down."

The questions presented are:

a. Whether petitioner's inventory write-down most clearly reflected its income under Section 471 of the Internal Revenue Code of 1954 and met the requirements of the controlling Treasury Regulations.

b. Whether petitioner's inventory write-down constituted a change of accounting method requiring the prior consent of the Commissioner under Section 446(e) of the Code.

2. Whether the Commissioner properly exercised his discretion under Section 166(c) of the Code in determining the reasonable addition to petitioner's bad debt reserve on the basis of its prior experience with respect to the collection of accounts receivable, rather than on the basis of its estimates of collectibility.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 166, 446, and 471 of the Internal Revenue Code of 1954 (26 U.S.C.) and Treasury Regulations on Income Tax, Sections 1.166-4, 1.446-1, 1.471-1, 1.471-2, and 1.471-4 (26 C.F.R.,) are set forth in the Appendix, *infra*, pp. 77-78.

STATEMENT

1. *Inventory write-down issue.* a. Petitioner is a manufacturer of tools, parts and accessories, and of various rubber articles. During 1964, the year in question, petitioner conducted its business at three plants in its Tool Division and at a fourth plant in its Rubber Division. Petitioner's three Tool Division plants maintained inventories of raw materials work-in-process, finished parts, and accessories. Its single Rubber Division plant maintained inventories of raw materials, work-in-process and completed products. Petitioner's 24 sales and service branches likewise maintained inventories of spare parts and accessories for each tool petitioner manufactured, as well as the complete tools. Petitioned employed the "lower of cost or market" method of valuing its inventory for both financial reporting and federal income tax purposes (Pet. App. A-8 to A-9, A-35).

When petitioner terminated the manufacture particular tools or models, it continued to stock replacement parts and accessories for those tools still in service. In 1960, petitioner established an inventory contra account entitled "Reserve for Inventory Valuation" (RIV) for the purpose of reducing the value of its closing inventory of replacement parts and accessories for discontinued tools. Petitioner thereafter began to amortize, over a ten-year period, the cost of its inventories of such items that were attributable to out-of-

production tools. Accordingly, petitioner credited its RIV account with ten percent of the cost of a part or accessory beginning with the year that it terminated production of the associated tool.[1] Petitioner subtracted these amounts from its closing inventory, thereby increasing its cost of goods sold and reducing its taxable income by corresponding amounts. Petitioner continued to reduce its closing inventories in accordance with this practice in both its financial statements and income tax returns for 1961, 1962, 1963, and through the first three quarters of 1964 (Pet. App. A-9 to A-10, A-35 to A-36).[2] Prior to its 1964 return, petitioner did not disclose either the existence of the inventory reserve account or its use in reducing its closing inventory and taxable income (Stip. of Facts, ¶¶ 2, 3, A. 23, 24).[3]

[1] Accordingly, on December 31, 1960, petitioner credited the RIV account with $116,244.52, reflecting a 100 percent write-off of parts and accessories for tools that it discontinued during and prior to 1950; a 90 percent write-down of parts and accessories for tools discontinued in 1951; and corresponding partial write-downs for parts and accessories for tools that were discontinued in subsequent years, ending with a 10 percent write-down of parts and accessories for tools discontinued in 1959 (Pet. App. A-9; Stip. of Facts, ¶6, A. 24).

[2] During 1960-1963, petitioner credited an aggregate of $152,117 to the inventory reserve and subtracted that amount from closing inventories. It credited an additional $22,090 to the reserve during the first three quarters of 1964, the year in issue (Pet. App. A-9 to A-10, A-35 to A-36; Stip. of Facts, ¶6, A. 24).

[3] Beginning in 1962, the corporate income tax return (Form 1120) contained a series of questions concerning inventory. The second question asked the taxpayer whether it made write-downs to inventory. "This question was unanswered in petitioner's 1962 and 1963 returns, but was answered in petitioner's 1964 return" (Stip. of Facts, ¶3). In its 1964 return, petitioner answered the question affirmatively and attached a schedule (Ex. 7-G, A. 226) disclosing the write-downs. Petitioner further stated in answer to the question on the return that its inventories "[were] stated on the same basis and were determined generally in the same manner as inventories at December 31, 1963 except that as a result of revision in operating policies made late in 1964, revised procedures were adopted to value excess stock" (*ibid.*).

In December 1964, new management assumed control of petitioner.[4] As part of their preparation of the 1964 financial statements, the new officers undertook "a complete re-evaluation of the assets and liabilities of the company," including "a physical inventory * * * at all locations" of the Tool and Rubber Divisions (A. 51, 52). The new management concluded that petitioner's existing quantities were in excess of anticipated market demand and that prior management had overstated inventory by reflecting it at full value. Accordingly, in preparing the 1964 financial statements, the new management adjusted petitioner's inventory to its "net realizable value," in accordance with accounting standards (Pet. App. A-10, A-36). In its 1964 annual report to its shareholders, petitioner characterized the extraordinary charge produced by the new inventory valuation procedures as resulting from "changes in accounting practices and principles" (Ex. P, A. 227).

[4] A proposed merger of petitioner into Stewart-Warner Corporation was abandoned in early December 1964, apparently because an investigation and audit convinced Stewart-Warner that petitioner's assets were overstated. The purchase agreement between the two companies was mutually rescinded at that time, and Stewart-Warner agreed to provide management assistance to petitioner. Accordingly, a Stewart-Warner employee assumed the presidency of petitioner on December 14, 1964 (Pet. App. A-10, A-36 n. 4; A. 50, 68).

Petitioner further explained that "[c]hanges were made in the methods of determining and valuing obsolete and excess inventory" (Ex. P, A. 232). However, in their report appended to its 1964 annual statement, petitioner's independent auditors cautioned that "[w]hile we believe the new [accounting] procedures to be reasonable in the circumstances, their appropriateness, particularly as they relate to inventory valuation, can only be adequately evaluated in the light of future events" (Ex. P, A. 233).[5]

In making the adjustments to its inventory accounts, petitioner considered obsolete all spare parts of tools that had never been offered for sale during 1964 or for which there had been no demand during 1964. This assumption resulted in an inventory write-down of approximately $2,750,000. The Commissioner did not challenge this write-down because petitioner scrapped the items in question soon after they were removed from its 1964 closing inventory. Petitioner also wrote off $245,000 of inventory reflecting parts stocked for three unsuccessful products (A. 56). The Commissioner did not question this second inventory write-down because petitioner sold the products at reduced prices soon after the write-down (Pet. App. A-36) (see also Ex. Q, A. 242).

b. Petitioner wrote down its remaining inventory, consisting of approximately 44,000 items, according

[5] The accountants' opinion was admitted into evidence to show that petitioner's 1964 annual report contained such an opinion but not for the purpose of proving the truth or the correctness of the matters discussed in it (A. 43, 233).

to its estimates of future demand. It is the write-down of these remaining items (considered by petitioner to be excess inventory) that is principally at issue in this case. With respect to the inventory at two of its Tool Division plants, petitioner's estimates were based upon 1964 sales figures and resulted in inventory write-downs of $744,030.[6] As petitioner's president explained, the 1964 sales figures were used as a basis because the company had no budget or forecast for the ensuing year (A. 57). However, because of the inadequacy of the sales data at the other two plants, petitioner reduced the value of the inventories of raw materials, work-in-process, and finished products by flat percentage adjustments. These adjustments resulted in inventory write-downs of $160,832 (Pet. App. A-10 to A-12, A-36 to A-37).[7]

[6] Petitioner reduced its gross usable inventory at these plants as follows (Pet. App. A-11, A-37 n. 6; Stip. of Facts, ¶9, A. 25-26):

"(1) Items not in excess of 12 months' anticipated demand were not written down.

"(2) Items in excess of 12 months' anticipated demand, but not in excess of 18 months' anticipated demand were written down 50 percent.

"(3) Items in excess of 18 months' anticipated demand but not in excess of 24 months' anticipated demand were written down 75 percent.

"(4) Items in excess of 24 months' anticipated demand were written off completely."

[7] Petitioner's flat percentage reductions in inventory valuation were as follows: (1) five percent for tool parts and motor parts at its LaGrange Park plant; (2) ten percent for raw materials, manuals and name plates, and work-in-process at LaGrange Park; (3) 50 percent for hardware at LaGrange Park; and (4) ten percent for raw materials, work-in-process, and finished goods at its Cincinnati plant (Pet. App. A-12, A-37 n. 7).

Since late 1964, petitioner has not attempted to sell at reduced prices any of the parts it estimated to be excess inventory. To the contrary, it continued to offer and sell them at their original prices. The market for such parts was confined to owners of the related tools who purchased replacement parts only when they needed them. However, the owners of related tools would not buy spare parts that they did not need simply because of price reductions (Pet. App. A–14, A–42 to A–43; A. 62). As petitioner's president conceded, petitioner "made no effort [to sell what it considered to be excess spare parts] except through the normal channels—normal prices to sell the service parts inventory" (A. 61). The same was the case for the raw materials, the finished tools and the work-in-process (A. 62–63). In its 1965 annual report to its shareholders, petitioner stated that "[t]he 1964 special charge consisted primarily of write-downs for obsolete and excess inventories which could not be allocated to specific periods because adequate information is not now available" (Ex. Q, A. 236). As in the case of the 1964 report, petitioner's independent auditors cautioned that "[w]hile the [inventory] reserves provided reflect the best current judgment of the company's management, it is not possible to evaluate these reserves prior to the ultimate disposition of the inventories involved" (Ex. Q, A. 243).[8]

Petitioner credited the total of these inventory write-downs to its inventory reserve contra account. The in-

[8] The accountant's opinion was admitted into evidence for the limited purpose of showing that petitioner's 1965 annual report contained such a caveat. See p. 6 n. 5, *supra*.

crease to this account reflected: (1) the $22,090 amortization that the prior management had claimed for the first three quarters of 1964; (2) the $744,030 write-down based upon petitioner's estimates of anticipated demand; and (3) the $160,832 write-down arising from flat percentage reductions. As of December 31, 1964, these write-downs increased petitioner's inventory reserve account by a total of $926,952, and resulted in a corresponding reduction of its closing inventory for 1964 for purposes of its 1964 financial statement and its income tax return. The reduction in closing inventory increased petitioner's cost of goods sold and thereby reduced its 1964 taxable income by $926,952 (Pet. App. A–12 to A–14, A–36 to A–37; A. 61).[9]

On audit, the Commissioner of Internal Revenue disallowed petitioner's three claimed reductions in the value of its inventory totalling $926,952 on the ground that they did not clearly reflect its 1964 income for tax purposes (Pet. App. A–37).[10] By amendment to his answer, the Commissioner advanced two additional

[9] Although petitioner's inventory write-downs at issue were for 1964, the Commissioner's disallowance resulted in a deficiency for 1963 because of a claimed net operating loss carryback under Section 172 (see A. 5–6).

[10] The Commissioner's notice of deficiency originally disallowed $1,079,069, the total credit balance in petitioner's inventory contra account at the end of 1964 (A. 3). However, the net addition to that account and equivalent reduction in petitioner's closing inventory and taxable income for 1964 was $926,952. Accordingly, the Commissioner conceded before the Tax Court that only the credits totalling $926,952 were at issue. He did not, however, concede the correctness of petitioner's method of computing the 1964 opening balance of $152,117 in the inventory contra account (Pet. App. A–37 to A–38 n. 8).

grounds for his disallowance of the inventory write-downs. First, that petitioner failed to value its opening inventory for 1964 in accordance with the method used to value its closing inventory. Second, that petitioner's new inventory valuation procedures constituted a change in its method of accounting, requiring the prior permission of the Commissioner under Section 446(e) of the Code (A. 20). Petitioner admitted that it did not obtain the Commissioner's consent to use its new inventory valuation procedures (A. 22).[11]

c. Petitioner sought review of the Commissioner's determination in the Tax Court. As the Tax Court noted, petitioner did not challenge the validity of the applicable Treasury Regulations promulgated under Sections 446 and 471. Instead, petitioner contended that its inventory valuation procedures complied with the Regulations. The Tax Court held that petitioner's write-down of excess inventory was not permitted by the Regulations. It therefore concluded that petitioner's claimed adjustments did not clearly reflect its income for 1964 and the Commissioner did not abuse his discretion by reducing petitioner's cost of goods sold and restoring that amount to income (Pet. App. A-30).

As the Tax Court pointed out, Section 1.471-4(a) of the Regulations had long been held to require that a taxpayer employing the lower of cost or market inventory method compute "market" value on the basis of replacement or reproduction cost rather than "net realizable value" (Pet. App. A-23 to A-24). Moreover, the Tax Court rejected petitioner's claim that its excess inventory was an extraordinary circumstance that justified its write-down to net realizable value on the basis of petitioner's estimates as to its ultimate salability. To the contrary, the court concluded that "the acquisition or production of such slow-moving units was a recurring, ordinary, and necessary incident of manufacturing, marketing, and maintaining petitioner's products" (Pet. App. A-26).

[11] Pursuant to petitioner's motion (A. 14-18), the Tax Court had previously ordered that the Commissioner would bear the burden of proof if he put in issue the change of accounting method question (A. 19).

Finally, the Tax Court held that petitioner's excess inventory was not analogous to damaged or imperfect items that Section 1.471-2 of the Regulations permits to be valued at bona fide sale prices less the cost of disposition. The court pointed out that at all events petitioner had not offered these items for sale at reduced prices (Pet. App. A-27 to A-28).[12] Accordingly, the Tax Court entered a decision finding a deficiency in petitioner's 1963 tax liability of $494,055.99 (A. 264).

The court of appeals affirmed (Pet. App. A-34 to A-48). It upheld the Tax Court's conclusion that

[12] The Tax Court did not reach the Commissioner's alternative arguments that: (1) petitioner's new inventory valuation procedure constituted a change in its method of accounting requiring the prior consent of the Commissioner under Section 446(e); and (2) that petitioner's inventory accounting did not clearly reflect its income because it did not employ consistent assumptions insofar as it failed to revalue its 1964 opening inventory in accordance with the methods used to value its closing inventory for that year (Pet. App. A-41 n. 12).

petitioner's inventory write-downs were not permitted by the applicable Treasury Regulations and that the Commissioner did not abuse his discretion under Sections 446 and 471 in determining that inventory that was not yet scrapped or otherwise shown to be without value by objective evidence could not be written off for tax purposes (Pet. App. A-41 to A-42).

In so holding, the court rejected petitioner's claim that its excess inventory was an exceptional circumstance that permitted market valuation under the lower of cost or market method to be set at other than replacement cost. See Treasury Regulations, Section 1.471-4 (26 C.F.R.) (Pet. App. A-43 to A-44). As the court observed, petitioner's "own chief executive officer stated that 'any business which is involved in the manufacture and sale of products inevitably must have excess inventory,' that this was particularly true in 'the kind of business that Thor was in * * * which involves a very high percentage of service parts and accessories,' and that many manufacturing costs are 'independent of quantity'" (Pet. App. A-43 to A-44; A. 54, 55).

Moreover, the court of appeals agreed with the Tax Court's determination that petitioner did not meet its burden of proving that its excess inventory was "unsalable at normal prices * * * because of damage, imperfection, shop wear, changes of style, odd or broken lots, or other similar causes * * *" within the meaning of Section 1.471-2(c) of the Regulations. The court further upheld the Tax Court's conclusion that this section of the Regulations was inapplicable because petitioner had not offered the items for sale at reduced prices (Pet. App. A-42 to A-43).

Finally, the court held that the fact that petitioner's inventory valuation procedures conformed to the best accounting practice did not control the question of the proper federal tax treatment of petitioner's inventory accounts. As the court noted, the Commissioner's broad discretion under Section 471 to regulate the use of inventory accounting rests upon a two-part test. The taxpayer's inventory method must conform to the best accounting practice in the particular trade or business and most clearly reflect its income (Pet. App. A-39). In the court of appeals' view, petitioner's inventory write-downs did not clearly reflect its income because the new method of valuation at "net realizable value" was not consistent with petitioner's prior method of inventory accounting (Pet. App. A-45).

Specifically, the court referred to the fact that although petitioner's excess inventory had been accumulated over a period of several years, "the new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years" (Pet. App. A-45). As the court observed, "* * * this large discrepancy was enough to indicate that consistency was lacking" (*ibid.*). The court therefore concluded that petitioner failed to meet the requirement of Section 1.471-2(b) of the Regulations that "[i]n order to clearly reflect income, the inventory practice of a taxpayer should be consistent from year to year * * *." Since petitioner's expert accountants did not testify that its

1964 income had been clearly reflected in its tax return or that its method of accounting was necessary in order to state its 1964 income, the court of appeals held that petitioner had not met its burden of proving that the Commissioner had abused his discretion in restoring the inventory write-downs to income (Pet. App. A-45 to A-46).

2. *Addition to bad debt reserve issue.* Petitioner employed the reserve method for deducting bad debts authorized by Section 166(c) of the Code. At the close of 1965, petitioner's new management estimated the collectibility of its accounts receivable. In the Tool Division, petitioner evaluated each 90-day-old account in excess of $100 and established a 100 percent reserve for the account in that category that is considered to be wholly uncollectible. Petitioner thereupon applied the dollar ratio of uncollectible accounts to total 90-day accounts exceeding $100 to its 90-day-old accounts that were less than $100. The resulting figure constituted the bad debt reserve for these smaller accounts. For all other 90-day account and all accounts between 30 and 90 days past due, petitioner established a flat two percent reserve. Finally, petitioner established a one percent reserve for all accounts less than 30 days old and for all accounts in the Rubber Division that it did not consider to be wholly uncollectible. These computations resulted in a total addition to petitioner's bad debt reserve of $136,150 for 1965. Petitioner deducted this

addition to its reserve on its 1965 tax return (Pet. App. A-16 to A-17, A-47).

On audit, the Commissioner rejected petitioner's method of computing the allowable additions to its bad debt reserve. Pursuant to his authority under Section 166(c) to allow reasonable additions to a reserve for bad debts in accordance with his discretion, the Commissioner recomputed petitioner's bad debt reserve on the basis of petitioner's actual collection experience pursuant to the formula approved in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula measures the current addition to the bad debt reserve based upon the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A. at 302). Accordingly, the Commissioner divided the total amount of accounts petitioner wrote off as worthless over the six-year period ending with the tax year in question ($940,413) by the total amount of year-end receivables for all six years ($30,063,802). The resulting percentage (3.12) was then applied to the 1965 year-end receivables ($4,927,967) to derive the allowable reserve as of that date ($154,146.80). Since petitioner's computations yielded a reserve of $228,947.60, the Commissioner disallowed the difference ($74,790.80) as a deduction for bad debts (Pet. App. A-16 to A-17, A-48; A. 3).

The Tax Court held that petitioner failed to sustain its burden of showing that the Commissioner's deter-

mination was an abuse of discretion. As the court pointed out, petitioner did not show that conditions at the end of 1965 made it less likely that its accounts receivable would be collected than in prior years. Indeed, the court concluded that collectibility was probably more likely at the end of 1965 than in at least some of the prior years because of the new management. It therefore rejected petitioner's contention that the Commissioner abused his discretion in rejecting its estimates as to collectibility because he based his determination upon past collection experience rather than current data (Pet. App. A-31 to A-32).

The court of appeals affirmed (Pet. App. A-47 to A-48). It characterized the showing that a taxpayer must make to overturn the Commissioner's disallowance of additions to a bad debt reserve as a "'heavy burden,'" observing that "the issue thus presented 'is whether the Commissioner's view is reasonable'" and "[i]f it is, the inquiry is ended" (Pet. App. A-48). In the court's view, "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (*ibid.*).

SUMMARY OF ARGUMENT

I

A. Inventories are a device for computing the cost of goods sold and thereby measuring a given year's income within an annual accounting system. The cost of the opening inventory plus the cost of goods acquired during the year minus the cost of the closing

inventory will yield the cost of goods sold during the year. Any reduction of the closing inventory will therefore increase the cost of goods sold, and correspondingly reduce income for the year. The question presented is whether petitioner could properly, while retaining its stock of goods unreduced in amount or price, write down its closing inventory of spare parts associated with the tools it manufactured by $926,592 because it estimated that its inventory would prove to be in excess of demand for such parts in future years.

We submit that the decision below correctly upheld the Comissioner's disallowance of petitioner's claimed inventory write-down. As both the Tax Court and the court of appeals recognized, Section 471 and the Treasury Regulations promulgated thereunder explicitly prohibit inventory write-downs based upon unverifiable estimated losses that are anticipated to occur in future years. That statute, which gives the Commissioner broad authority for prescribing inventory methods of accounting that "most clearly reflect[] the income of the taxpayer," has its genesis in the Revenue Act of 1918, and it, as well as the controlling Regulations that were issued in 1922, have been carried forward without substantial change.

The Regulations provide the specific directions that required the Commissioner to disallow petitioner's claimed write-down of $926,952 in its closing inventory for 1964. On the other hand, they permitted petitioner to write down its inventory by $2,750,000 for goods that were obsolete and scrapped, and by an

additional $245,000, reflecting goods relating to unsuccessful products that were offered for sale at reduced prices. "[I]t is fundamental * * * that as 'contemporaneous constructions by those charged with administration of' the Code, [Treasury] Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes' and 'should not be overruled except for weighty reasons.'" *Bingler* v. *Johnson,* 394 U.S. 741, 749–750, quoting from *Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496, 501. This rule of deference is particularly appropriate here since the Regulations in question were issued pursuant to the express statutory authority of Section 471, and constitute a longstanding administrative interpretation that has been in effect during successive reenactments of the statute. *Helvering* v. *Winmill,* 305 U.S. 79; *Lykes* v. *United States,* 343 U.S. 118. Thus, the detailed Regulations that govern this case squarely support the Commissioner's differentiated treatment of petitioner's claimed inventory write-downs.

B. Petitioner's inventory write-downs of items it continued to hold for sale at unreduced prices are barred by the controlling Treasury Regulations under Section 471. Petitioner premises its claim for accounting autonomy upon a universalized reading of a single sentence in Section 1.471–2 of the Regulations, which states that an inventory method that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly

reflecting the taxpayer's income. Petitioner assumes a sweeping and open-ended scope for this statement, and ignores the fact that the phrase "as a general rule" necessarily connotes exceptions. Moreover, petitioner's broad construction of this single sentence as a universal principle cannot stand in the face of the particularized provisions of Regulations, the validity of which it does not explicitly challenge.

Finally, petitioner overlooks the fact that the same paragraph of the Regulations provides that "greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation * * *." But the Tax Court found and the court of appeals agreed that petitioner valued its opening inventory on a different basis from that of its closing inventory for that year. Thus, the decision can be affirmed on this independent ground.

Whatever weight might be given to the sentence relied upon by petitioner if it stood alone, it cannot modify the explicit provisions of paragraph (f) of the same Section 1.471–2, which sets forth five methods of valuing inventories that are disapproved for federal income tax purposes. The first three of these five, which overlap to some extent, describe in whole or in part the methods by which petitioner wrote down its inventories by $926,952, *ie.,* (1) deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof; (2) taking parts of the inventory at a nominal price, or at less than proper value; (3) omitting portions of the stock on hand. These provisions required the Commissioner's disallowance of petitioner's write-downs.

Nor does Section 1.471-2(c) of the Regulations support petitioner's claimed write-down. That provision permits an inventory reduction to bona fide selling price less direct cost of disposition for goods suffering from damage, imperfections, or other similar causes. But the courts below correctly held this provision inapplicable because petitioner's inventory deemed excess was not physically differentiated from the remainder of its inventory. At all events, Section 1.471-2(c) is inapplicable because, as the court of appeals also pointed out, it authorizes a write-down only if goods in question are sold or offered for sale at reduced prices within 30 days of the inventory date. Petitioner acknowledges that it failed to meet this requirement of the Regulations because it continued to hold its inventory for sale at unreduced prices.

Petitioner's reliance upon Section 1.471-4 of the Regulations, dealing with the valuation of inventories at the lower of cost or market, is similarly misplaced. As that Section of the Regulations makes clear, the term "market" refers to replacement cost, and not to the figure at which the taxpayer might sell its goods. Thus, even on the assumption that petitioner's estimate otherwise would require acceptance, its attempt to justify its reduction of inventory to "net realizable value" squarely conflicts with the Regulation's treatment of "market" as approved by numerous court decisions. Other provisions in the same section dealing with situations of restricted or inactive markets correlate inventory valuations with the taxpayer's proven sale prices at times before and after the inventory date. Since petitioner acknowledges its sale prices were unreduced, this section does not justify, but disapproves, its reduction in inventory values. Finally, Section 1.471-4 requires that where the inventory is valued at the lower of cost or market, each item of the inventory must be valued. Petitioner's use of an estimated value of the aggregate inventory is therefore explicitly disapproved by the Regulations.

C. Petitioner also seeks to justify its $926,952 write-down on the broader ground that it was consistent with generally accepted commercial accounting practices. While commercial accounting practices could hardly override the specific provisions of the controlling Regulations, the language of Section 471 establishes that the clear reflection of income standard is independent of commercial accounting considerations and that the Commissioner has wide latitude in determining whether a taxpayer's method of inventory accounting clearly reflects its income. As the introductory clause of the statute provides, the purpose of taking inventories is "in order clearly to determine the income of any taxpayer" and accounting rules are simply means to that dominant end. Thus, the question of conformity to "the best accounting practice in the trade or business" is not to be determined by the accounting profession but is to be resolved by "the opinion of the Secretary, on such basis as [he] may prescribe * * *," *i.e.,* the Regulations.

Moreover, an unbroken line of decisions of this Court confirms that generally accepted commercial ac-

counting practices do not govern the computation of federal income tax liability. See, *e.g.*, ***American Automobile Assn.*** v. ***United States,*** 367 U.S. 687; ***Schlude*** v. ***Commissioner,*** 372 U.S. 128; ***United States*** v. ***Catto,*** 384 U.S. 102. What constitutes a fair and accurate statement of a taxpayer's income in a report to creditors or stockholders, or even for purposes of complying with some other statute, does not necessarily coincide with what must be reported as income under the taxing statute; each report is designed to serve discrete needs and objectives. Accordingly, the Court has consistently rejected attempts by taxpayers to reduce their taxable income by the use of reserves in anticipation of future losses. "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions" (footnote omitted). *Lucas* v. *American Code Co.,* 280 U.S. 445, 452; *Brown* v. *Helvering,* 291 U.S. 193, 202.

Here, too, petitioner's accountants may have properly concluded that its $926,952 write-down of purportedly excess inventory was required in order to project a fair and conservative statement of its financial condition. But petitioner sustained no identifiable loss in the year of the write-down either by scrapping the items in question or offering them for sale at reduced values. To the contrary, petitioner continued to hold them for sale at their original prices. It therefore took no steps to confirm the accuracy of its estimated loss as required by the Regulations. Thus, petitioner's inventory write-down is nothing more than

a reserve to cover a contingency for an anticipated loss that may arise in the future. It cannot be taken into account in computing its current income.

D. Even if petitioner's reduction in its 1964 closing inventory were otherwise permitted under Section 471 and the controlling Treasury Regulations, its adoption constituted a change in accounting method which required the prior consent of the Commissioner under Section 446(e) of the Code. It is undisputed that petitioner did not seek and that the Commissioner did not give such consent (A. 22). Although neither the Tax Court nor the court of appeals reached this question (Pet. App. A-30, A-41 n. 12), the decision below that the Commissioner did not abuse his discretion in disallowing petitioner's adjustment to its 1964 closing inventory can be affirmed on this independent ground alone. See, *e.g.*, ***Dandridge*** v. ***Williams,*** 397 U.S. 471, 475-476 n. 6; ***LeTulle*** v. ***Scofield,*** 308 U.S. 415; ***Langnes*** v. ***Green,*** 282 U.S. 531.

II

The court of appeals also correctly held that the Commissioner did not abuse his discretion in rejecting petitioner's method of computing its bad debt reserve. Section 166(a) of the Code permits a taxpayer to claim a deduction for specific debts as they become worthless. Section 166(c) provides that, in lieu of the specific write-off method authorized by Section 166(a), "there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts." A

reasonable addition to a bad debt reserve is the amount necessary to bring the balance in the reserve account to a level that can be reasonably expected to cover the losses anticipated with respect to debts outstanding at the end of the year. *Dixie Furniture Co.* v. *Commissioner,* 390 F. 2d 139 (C.A. 8).

At the close of 1965, petitioner estimated the collectibility of each of its accounts. It set aside a 100 percent reserve for specific accounts it considered to be wholly uncollectible. It also applied the dollar ratio of uncollectible accounts to the total amount of accounts of more than $100 and applied this fraction to 90-day-old accounts with a balance of under $100. Moreover, it established a flat two percent reserve for all other 90-day accounts and all accounts between 30 and 90 days past due. Finally, petitioner established a one percent reserve for all accounts less than 30 days old (Pet. App. A-47). These computations resulted in a total addition to petitioner's bad debt reserve of $135,150 (Pet. App. A-48).

Pursuant to his authority under Section 166(c), the Commissioner recomputed petitioner's bad debt reserve by applying the formula approved in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula, which the courts have consistently approved as a "reasonable" method of computing a reserve for bad debts, measures the current addition to the bad debt reserve based upon the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A.

at 302). The *Black Motor* formula yielded an addition to petitioner's bad debt reserve of $74,790.80 (Pet. App. A-48).

As the court of appeals properly observed, Section 166(c) gives the Commissioner broad discretion to determine the reasonableness of any addition by a taxpayer to a bad debt reserve. In order to overturn the Commissioner's determination, the taxpayer must show an abuse of that discretion. *Calavo, Inc.* v. *Commissioner,* 304 F. 2d 650, 653-655 (C.A. 9); *Consolidated-Hammer Dry Plate & Film Co.* v. *Commissioner,* 317 F. 2d 829, 834 (C.A. 7); *Akron National Bank & Trust Co.* v. *United States,* 510 F. 2d 1157 (C.A. 6); *Merchants Industrial Bank* v. *Commissioner,* 475 F. 2d 1063 (C.A. 10); *Paramount Finance Co.* v. *United States,* 304 F. 2d 460 (Ct. Cl.). Petitioner has not done so.

Rhode Island Hospital Trust Co. v. *Commissioner,* 29 F. 2d 339 (C.A. 1), *Calavo, Inc.* v. *Commissioner, supra,* or *Travis* v. *Commissioner,* 406 F. 2d 987 (C.A. 6), are not to the contrary. In each of those cases, the courts reaffirmed the Commissioner's statutory discretion with respect to bad debt reserves. However, the taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve was an abuse of discretion. Here, on the other hand, petitioner failed to make that showing. The court of appeals correctly concluded that "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (Pet App. A-48).

271-212—78——5

ARGUMENT

I

PETITIONER'S REDUCTION OF ITS CLOSING INVENTORY TO AN ESTIMATED NET REALIZABLE VALUE DID NOT CLEARLY REFLECT ITS INCOME UNDER SECTION 471 OF THE CODE BECAUSE THE CONTROLLING TREASURY REGULATIONS PROHIBIT THE CURRENT DEDUCTION OF ESTIMATED FUTURE LOSSES

A. INTRODUCTION

The principal question presented in this federal income tax case is whether petitioner's method of valuing its inventory clearly reflected its income within the meaning of Section 471 of the Internal Revenue Code of 1954 (26 U.S.C.) and the controlling Treasury Regulations.[13] Section 471 is the current version of a long line of similar provisions since the Revenue Act of 1918, 40 Stat. 1057 that have accorded to the Commissioner of Internal Revenue the determination whether the use of inventories is necessary in order to clearly determine the income of any taxpayer. If the Commissioner determines that inventories are necessary, the statute requires that "inventories shall be taken by such taxpayer on such basis as the [Commissioner] may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

[13] Both the *amicus* brief filed by the National Association of Manufacturers (p. 4) in support of the petition and petitioner's reply to the government's brief in opposition urged that the question presented was of substantial administrative importance. Thus, petitioner's reply stated that "there are 371 cases docketed in the Tax Court and an unknown number pending in Federal District Courts involving the valuation of excess inventory. There are an additional 493 cases pending in the Appellate Division [of the Internal Revenue Service] and an estimated several times that number in the Audit Division of the Internal Revenue Service, a substantial number of which inevitably will find their way into the courts" (p. 1).

While the number of pending cases within the Audit Division cannot be readily ascertained, the Internal Revenue Service "Reports and Information Retrieval Activity" (RIRA) discloses that the figures cited by petitioner are somewhat misleading. The RIRA list of pending Tax Court cases included 380 cases presenting a "lower of cost or market" inventory issue. But of those 380 cases, 374 represented a single case involving a chain of department stores, each of which was separately incorporated and required a separate petition and docket number (see Belk-Leggett Department Stores, Nos. 11027–75 through 11400–75). The issue was whether certain inventory items belong in various "retail markup" categories under the retail method of inventorying, which is authorized for use only by retail merchandisers under Treasury Regulations, Section 1.471–8. The Service has advised us that this case (or 374 cases) will be settled without trial.

Of the other six pending Tax Court cases, two involve the valuation of excess inventory. Venue for one (*Altec Corporation* v. *Commissioner*, P-H Memo T.C., para. 77,438, December 29, 1977) would lie in the Seventh Circuit. The other case is *Will-Burt Co.* v. *Commissioner*, T.C. Docket No. 1989–76. The remaining four cases are either not on point or are being settled. *Curtis Electric Lighting Co.* v. *Commissioner*, No. 1933–70; *Towel Towns of America* v. *Commissioner*, No. 3129–77; *Rockwell International* v. *Commissioner*, No. 3121–77; *Universal Sporting Goods, Inc.* v. *Commissioner*, No. 239–78. Finally, on March 24, 1978, a petition was filed in the Tax Court in an additional case that appears to involve the issue of excess inventory (*Sargent-Welch Scientific Co.* v. *Commissioner*, No. 3148–78).

Likewise, the RIRA report showing cases pending in the Appellate Division of the Service indicates that there are 382 cases

Inventories are a well-established accounting device for computing the cost of goods sold. See *Rouss* v. *Bowers*, 30 F. 2d 628, 629 (C.A. 2), certiorari denied, 279 U.S. 853; 2 Mertens, *Law of Federal Income*

Taxation § 16.03 (1974 Rev.). The inventory method of accounting permits a taxpayer to compute his cost of goods sold without necessarily identifying those goods on an item-by-item basis. Even before the revenue acts contained any provisions with respect to methods of accounting, it was recognized that if a merchant bought a stock of goods in one year and sold them in the following year, his income would not be properly reflected for either year if he took a deduction for the cost of the goods in the first year and reported the entire selling price as income in the second year. As this Court recognized in *United States* v. *Catto*, 384 U.S. 102, 109, "[t]he general and long-standing rule for all taxpayers, whether they use the cash or accrual method of accounting, is that costs incurred in the acquisition, production, or development of capi-

pending in the same category, including the 374 cited above. Of the remaining eight cases listed, five do not involve the question presented here. (Four of those cases relate to the same taxpayers.) Two of the remaining cases involve related taxpayers and the taxpayers have conceded the issue presented here. In the last case, which is pending in Chicago, venue would lie in the Seventh Circuit. Since these cases are not reflected in any public record, Section 6103 of the Internal Revenue Code (26 U.S.C.) prohibits disclosure of the taxpayers' names.

To the extent that this Court may have granted certiorari on the assumption that the question presented was of public importance, the foregoing information indicates that the "special and important reasons" required by Rule 19 for discretionary review by this Court are lacking in this case. In these circumstances, the Court may wish to consider whether the writ of certiorari should be dismissed as improvidently granted. See *Rudolph* v. *United States*, 370 U.S. 269; *Rice* v. *Sioux City Cemetery*, 349 U.S. 70, 76–80, and 78 n. 2.

tal assets, inventory, and other property used in the trade or business may not be currently deducted, but must be deferred until the year of sale, when the accumulated costs may be set off against the proceeds of the sale" (footnote omitted).

Accordingly, the early Treasury Regulations defined gross income from the sale of goods as the difference between the price received and the cost of goods sold and prescribed the use of inventories to compute the cost of goods sold.[14] The cost of goods sold may be determined by taking the cost of goods in the opening inventory, adding the costs of goods acquired during the year, together with any labor and material expenses, and subtracting the cost of goods in the closing inventory. See *Frank G. Wikstorm & Sons, Inc.* v. *Commissioner*, 20 T.C. 359, 361.

The mechanics of the computation of costs of goods sold can be illustrated by the following example of a taxpayer who buys old bicycles, rebuilds them with new parts, and sells them. At the beginning and end of its taxable year, it had inventories of $5,200 and $6,000, respectively. During the current taxable year, it paid $4,000 for old bicycles, $1,200 for labor in renovating them, and $1,000 for new parts. The computation of cost of goods sold and gross profit for the taxable year would be as follows:

[14] See Treasury Regulations 31 (Excise Tax Act of August 5, 1909), Arts. 2(3) and (4), 5; Treasury Regulations 33 (Income Tax Act of 1913), Arts. 104, 105, 161; Treasury Regulations 33 (Revised) (Revenue Act of 1916), Arts. 91, 92, 120.

1. Gross receipts		$11,000
2. Opening inventory	5,200	
3. Merchandise bought	4,000	
4. Labor	1,200	
5. Supplies	1,000	
6. Total	11,400	
7. Closing inventory	(6,000)	
8. Cost of goods sold		5,400
9. Gross profit		5,600

It can be seen from the foregoing example that, if other factors are constant, a reduction in the closing inventory will result in a corresponding increase in cost of goods sold and a decrease in current income. The smaller the valuation accorded to closing inventory, the larger the ~~account~~ amount attributable to goods sold during the current year, the cost of which may be currently deducted and need not be deferred to a future period. As the Court pointed out in *Lucas* v. *Structural Steel Co.,* 281 U.S. 264, 268, "[t]he Federal income tax system is based upon an annual accounting period. This requires that gains or losses be accounted for in the year in which they are realized. The purpose of the inventories is to assign to each period its profits and losses."

B. PETITIONER'S INVENTORY WRITE-DOWNS OF ITEMS IT CONTINUED TO HOLD FOR SALE AT UNREDUCED PRICES ARE BARRED BY THE CONTROLLING TREASURY REGULATIONS

1. In this case, petitioner's new management made three large-scale reductions to its closing 1964 inventory, thereby increasing its cost of goods sold for that year and reducing its taxable income. First, peti-

tioner wrote down its closing inventory by $2,750,000 to reflect items that were thereafter scrapped because they were obsolete. Second, petitioner reduced its closing inventory by $245,000 to reflect spare parts stocked for unsuccessful products. Shortly thereafter, petitioner offered and sold these parts at reduced prices. The Commissioner did not question either of these write-downs (Pet. App. A-36). What is at issue here is the Commissioner's disallowance of petitioner's third claimed inventory reduction of $926,952, representing percentage write-downs of items that petitioner estimated to be in excess of its future needs but which it continued to hold for sale at their original prices.

We submit that both courts below correctly upheld the Commissioner's disallowance of petitioner's third inventory write-down. As we shall now demonstrate, the Commissioner's differentiated treatment of petitioner's three inventory reductions is specifically required by the controlling Treasury Regulations. With respect to the inventory write-down question at issue in this case, these Regulations have been substantially unchanged since their promulgation under essentially identical statutory provisions more than 50 years ago by T.D. 3296, I-1 Cum. Bull. 40 (1922). The Regulations explicitly prohibit reductions of inventory on the basis of estimated changes in value in the absence of objectively determinable standards of actual pricing. Since petitioner continued to hold the inventory items in question for sale at their original prices, its write-downs from cost to net realizable value are barred by the Regulations. As the Tax

Court observed with respect to an analogous inventory reduction claim, "[r]ecognition of the device employed by the petitioner would be clearly violative of the long established rule that the revenue laws only permit the deduction of realized losses and not anticipated losses. *Weiss* v. *Wiener,* 279 U.S. 333; *Lucas* v. *American Code Co.,* 280 U.S. 445. This rule applies with equal effect to those taxpayers properly employing inventories." *Gunderson Bros. Engineering Corp.* v. *Commissioner,* 16 T.C. 118, 129. See also 2 Mertens, *supra,* at §§ 16.25, 16.28.

2. a. The specific authorization for the Treasury Regulations dealing with inventories is Section 471 of the 1954 Code, which has its origin in Section 203 of the Revenue Act of 1918, 40 Stat. 1060.[15] It has

[15] Prior to the enactment of the Revenue Act of 1918, the Secretary had authorized the use of the lower of cost or market method of inventory valuation. See T.D. 2609, 19 Treasury Decisions, Internal Revenue 401 (1917). In recognition of doubts as to his authority in this respect, the Secretary made the earlier decision tentative. T.D. 2649, 20 Treasury Decisions, Internal Revenue 26 (1918). Subsequently, the Attorney General issued an opinion (31 Op. Att'y Gen. 301 (1918)) supporting the Secretary's authority. The Secretary thereupon affirmed T.D. 2609 in T.D. 2744, 20 Treasury Decisions, Internal Revenue 455 (1918). For a description of the operation of the early regulations, see *Willard Mfg. Co.* v. *Kennedy*, 109 F. 2d 83 (C.A. 2).

The Revenue Act of 1918 (approved on February 24, 1919) also contained provisions in Sections 214(a)(12)(a) and 234(a)(14)(a), respectively applicable to individuals and corporations. These provisions were limited in application to the taxable year 1918 and permitted taxpayers to reflect the loss (whether or not realized) or shrinkage in inventory values at the end of 1918 due to oversupply of many items at the end of World War I. See S. Rep. No. 617, 65th Cong., 3d Sess. 8 (1918).

remained essentially unchanged through the enactment of the intervening revenue acts and the Internal Revenue Codes of 1939 and 1954. The statute in 1964 provided:

> Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

As the introductory clause states, the purpose of taking inventories is "in order clearly to determine the income of any taxpayer." Under the statute, accounting rules are simply means to that dominant end. Thus, the question of conformity to "the best accounting practice in the trade or business" is not to be determined by the accounting profession but, "on such basis as the Secretary or his delegate may prescribe * * *," *i.e.,* the Regulations. The courts therefore early recognized that "from the language of the statute itself the basis of the inventories was one peculiarly confided to the commissioner; that to him was left the ascertainment 'of the best accounting practice in the trade or business', * * * a task difficult for the courts and one, which if entered upon by the courts, would, no doubt result in many different bases for inventories * * *." *Riverside Mfg. Co.* v. *United States,* 67 Ct. Cl. 117, 126, certiorari denied, 279 U.S. 863. See

271-212—78——6

also *Bedford Mills, Inc.* v. *United States*, 59 F. 2d 263, 269 (Ct. Cl.); *Montreal Mining Co.* v. *Commissioner*, 2 T.C. 688, 694.[16]

Pursuant to this statutory authority, the Commissioner promulgated Treasury Regulations 45 (1920 ed.) (Revenue Act of 1918), Arts. 1581–1588, which, as amended in 1922 by T.D. 3296, I-1 Cum. Bull. 40, have remained substantially unchanged through the numerous reenactments of the basic statute.[17] See *Knapp King-Size Corp.* v. *United States*, 527 F. 2d 1392, 1400 (Ct. Cl.). They currently appear as Treasury Regulations, Sections 1.471–1 through 1.471–8 (26 C.F.R.), of which Sections 1.471–2 and 1.471–4, Appendix, *infra*, pp. 84–88, are of particular relevance here.

b. As the court of appeals correctly observed (Pet. App. A–38 to A–39), both Sections 446 and 471 empower the Commissioner to determine the propriety of a taxpayer's method of accounting in accordance

[16] In several cases, the Tax Court has rejected evidence of trade practices in valuing inventories. See *Brooks-Massey Dodge, Inc.* v. *Commissioner*, 60 T.C. 884, 889; *Estate of Jones* v. *Commissioner*, 20 T.C.M. 26; *Estate of Ginsberg* v. *Commissioner*, 17 T.C.M 472.

[17] See Treasury Regulations 62 (Revenue Act of 1921), Arts. 1581–1588; Treasury Regulations 65 (Revenue Act of 1924), Arts. 1611–1618; Treasury Regulations 69 (Revenue Act of 1926), Arts. 1611–1618; Treasury Regulations 74 (Revenue Act of 1928), Arts. 101–108; Treasury Regulations 77 (Revenue Act of 1932), Arts. 101–108; Treasury Regulations 86 (Revenue Act of 1934), Arts. 22(c)–1 to 22(c)–8; Treasury Regulations 94 (Revenue Act of 1936), Arts. 22(c)–1 to 22 (c)–8; Treasury Regulations 101 (Revenue Act of 1938), Arts. 22(c)–1 to 22(c)–8; Treasury Regulations 103 (1939 Code), Sections 19.22(c)–1 to 19.22(c)–8; Treasury Regulations 111 (1939 Code), Sections 29.22(c)–1 to 29.22(c)–8; Treasury Regulations 118 (1939 Code), Sections 39.22(c)–1 to 39.22(c)–8.

with a "clear reflection of income" standard. Section 446 provides that taxable income shall be determined "under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books" "[unless] the method used does not clearly reflect income * * *." In that case, "the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." Similarly, Section 471 requires that the Regulations prescribed thereunder conform "as nearly as may be to the best accounting practice in the trade or business *and as most clearly reflecting the income*" (emphasis added). While both provisions make relevant accounting practices, they do not regard that factor as controlling for federal tax purposes if the method does not clearly reflect income.

The statutory language therefore refutes petitioner's claim (Br. 24–31) to accounting autonomy from the requirements of the Regulations on the ground that its inventory valuation procedures conformed to generally accepted commercial accounting practices. All petitioner's reading (Br. 31–34) of the legislative history of Sections 446 and 471 establishes is that conformity to generally accepted accounting practices is a relevant but not controlling factor in determining the propriety of an accounting method for tax purposes under the clear reflection of income standard. To be sure, Section 446(a) and its predecessors since 1918 have required that the taxpayer com-

pute its taxable income in accordance with the method of accounting employed in keeping its books. But this general rule is immediately qualified by the "exception" in Section 446(b), which also originated in the Revenue Act of 1918, that "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." The Regulations under Section 446 are to the same effect. While Section 1.446-1(a)(2) provides that a generally accepted method of accounting "will ordinarily be regarded as clearly reflecting income * * *," it also states that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." [18]

Thus, contrary to petitioner's submission, there is no statutory presumption that a generally accepted method of accounting will be regarded as clearly reflecting income if it does not comply with the Regulations. As the court of appeals pointed out (Pet. App. A-39 to A-40), the term "ordinarily" in Section 1.446-1(a)(2) of the Regulations suggests that there can be circumstances in which generally accepted accounting practices do not clearly reflect income. Indeed, to the extent that Congress created a presumption, it is in favor of the Commissioner's judgment that

[18] Moreover, the Regulations also provide that an accounting method used by the taxpayer will be acceptable only "if it accords with generally recognized and accepted *income tax accounting principles* and is consistently used by the taxpayer from year to year." Treasury Regulations, Section 1.446-1(c)(ii) (emphasis added).

a method of accounting does not clearly reflect income. That judgment can only be set aside if the taxpayer meets the "heavy burden of proving that the Commissioner's action was plainly arbitrary." *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 271. As this Court stated in *Brown* v. *Helvering*, 291 U.S. 193, 204-205, "It is not the province of the court to weigh and determine the relative merits of systems of accounting." See also *Lucas* v. *American Code Co.*, 280 U.S. 445, 449; *United States* v. *Catto*, *supra*, 384 U.S. at 114.

3. The current version of the detailed Regulations covers inventories generally (Sections 1.471-1 through 1.471-4), and also, as Section 471 mandates, establishes standards with respect to a number of specific trades or businesses: dealers in securities (Section 1.471-5), livestock raisers and other farmers (Section 1.471-6), miners and manufacturers (Section 1.471-7), and retail merchants (Section 1.471-8). "[I]t is fundamental * * * that as 'contemporaneous constructions by those charged with administration of' the Code, [Treasury] Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes' and 'should not be overruled except for weighty reasons.'" *Bingler* v. *Johnson*, 394 U.S. 741, 749-750, quoting from *Commissioner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501. Accord: *Fulman* v. *United States*, No. 76-1137, decided February 22, 1978, slip op. 5; *United States* v. *Correll*, 389 U.S. 299, 306-307.

This rule of deference is particularly appropriate here since the Regulations in question were issued pursuant to the express statutory authority of

Section 471, and constitute a long-standing administrative interpretation that has been in effect during successive reenactments of the statute. *Helvering* v. *Winmill,* 305 U.S. 79; *Lykes* v. *United States,* 343 U.S. 118. Thus, in upholding the validity of the inventory Regulations in Section 1.471–6(f) with respect to livestock raisers, this Court reaffirmed its earlier decisions holding that "Congress has granted the Commissioner broad discretion in shepherding the accounting methods used by taxpayers," and that " 'It is not the province of the court to weigh and determine the relative merits of systems of accounting.' " *United States* v. *Catto, supra,* 384 U.S. at 114.

We therefore turn to the detailed provisions of the Regulations upon which this case must ultimately turn. Section 1.471–1, Appendix, *infra,* p. 84, establishes the requirement for inventories in enterprises in which the sale of merchandise is an income-producing factor. Section 1.471–2, Appendix, *infra,* pp. 84–86, deals generally with valuation of inventories. Paragraph (a) of that Section reaffirms the statutory requirement that each inventory (1) must conform as nearly as may be to the best accounting practice in the trade or business, and (2) must clearly reflect the income. With respect to accounting practices, Section 1.471–2(c) in turn provides that "The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower." Petitioner, of course, has purported to employ the inventory method of cost or market, whichever is lower.

However, as we shall show, its practice does not conform either to Section 1.471–2, governing inventory valuation generally, or to Section 1.471–4, governing the lower of cost or market method.

Paragraph (b) of Section 1.471–2 acknowledges that inventory rules cannot be uniform but must take trade customs into account, emphasizes the weight given to consistent inventory practice from year to year,[19] and then sets forth the sentence that petitioner argues (Br. 18, 21, 32, 34, 40, 41, 64) controls this case. That sen-

[19] Since inventories are a device employed in an annual accounting system to measure the cost of goods sold, and ultimately income, in each year of a series of years, the consistency requirement of the Regulations makes it necessary that the opening inventory and the closing inventory of each year be valued on the same basis and embody the same assumptions, that the closing inventory of one year be the opening inventory of the next, and that the practice from year to year be consistent. One ground for the Commissioner's disallowance of the write-down here in question was that petitioner's opening and closing inventories for 1964 were not valued on the same basis. The Tax Court (Pet. App. A–25 to A–26) found that nothing occurring in 1964 supported the write-downs at the end of that year but that it was a fair inference from the record that the accumulation of excess inventory occurred over a period of several years. Since petitioner claimed $4 million of inventory write-downs for 1964, as compared with a small fraction of that amount for preceding years, the Tax Court found that its opening inventory for 1964 was valued at a different basis from that of its closing inventory.

This factual finding can serve as an independent basis for disallowance of petitioner's 1964 write-down and affirmance of the decision below even if petitioner's legal position were otherwise sound. As the court of appeals pointed out (Pet. App. A–45), this internal inconsistency in petitioner's accounting rebutted any presumption that might have been created by the sentence in Section 1.471–2 upon which petitioner relies.

Petitioner does not directly challenge the correctness of the Tax Court's finding that its 1964 inventory valuation was inconsistent

tence states: "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income." Petitioner would have this sentence serve as a universal standard that should be read in a vacuum so as to override other specific provisions of the Regulations. But as the court of appeals pointed out (Pet. App. A-39 to A-40), the phrase "'as a general rule'" suggests that there are exceptions and differences applicable to specific situations. Moreover, the immediately preceding sentence of Section 1.471-2(b) states that "greater weight is to be given to consistency * * * *so long as the method or basis used is substantially in accord with §§ 1.471-1 through 1.471-9*" (emphasis supplied). It therefore cannot be argued that the Regulations leave the question whether a particular method meets the clear reflection of income standard to the taxpayer's conformity to accepted commercial accounting practices. For if such were the case, it would virtually render meaningless the detailed provisions of Sections 1.471-1 through 1.471-9 of the Regulations.

4. At all events, whatever persuasive force might be attributed to the "general rule" if it stood alone is rebutted by the specific disapprovals of inventory

because the excess inventory was accumulated over a period of years. Instead, it argues (Br. 52-53) that any such inconsistency favored the revenues by causing it to have overstated its income for years prior to 1964. But the only year before the Court is 1964. Petitioner cannot invoke alleged overpayments for its prior closed taxable years that are not at issue as a ground for the propriety of its inventory write-downs for 1964.

methods that are set forth in paragraph (f) of the same Section 1.471-2. That paragraph provides as follows:

> (f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:
>
> (1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.
>
> (2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.
>
> (3) Omitting portions of the stock on hand.
>
> (4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.
>
> (5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

Of the five enumerated methods of valuing inventories that are specifically disapproved by the Regulations, the first three, which overlap to some extent, describe the methods by which petitioner wrote down its closing 1964 inventory, or some phase of those methods.

a. *Section 1.471-2(f)(1)*. Subparagraph (1) accurately describes the process by which petitioner reduced its inventory to what it describes as "net realizable value." Anticipating future losses from its inventory of parts that it estimated might prove to be in excess of its needs, and therefore of diminishing value, petitioner's former management in 1960 established a "Reserve for Inventory Valuation," increased this

reserve each year through the first three quarters of 1964 by ten percent of the cost of parts constituting the basis of the reserve, and deducted the increase from its closing inventory at the end of each year. For years prior to 1964, petitioner did not disclose this fact on its income tax returns. The new management that took over in late 1964 employed the same mechanism, but on a much larger scale, and with greatly increased percentage reductions in inventory. Each inventory reduction sought by the reserve mechanism to anticipate future losses and to reduce income for the current year by the amount of those losses estimated to occur in later years.

But the annual accounting requirement upon which our tax system is based does not permit a taxpayer to vault the barrier of the taxable year and deduct losses that may occur in future years. Section 1.471-2(f)(1) implements that fundamental principle and therefore prohibits "[d]educting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof." See 2 Mertens, supra, at § 16.28. Given this explicit prohibition in the Regulations, it is hardly surprising that the courts have rejected such percentage write-downs of inventory, whether the anticipation of diminished realization arose from changes in styles or general price levels, excess supplies, supervening technology, disadvantageous changes in the geographic or business environment, or otherwise.[20] In seeking write-downs based upon estimates

[20] See, *e.g.*, *John L. Ashe, Inc.* v. *Commissioner*, 214 F. 2d 13 (C.A. 5); *Western Dry Goods Co.* v. *United States*, 34 F. 2d 976 (W.D. Wash.); *S & R Chevrolet Co.* v. *Birmingham*, 93 F. Supp. 950, 96-963 (N.D. Iowa); *Brooks-Massey Dodge, Inc.* v. *Commissioner*, 60 T. C. 884; *Pearl* v. *Commissioner*, 36 T.C.M. 1059; *Rogers* v. *Commissioner*, 20 T.C.M. 1515; *Estate of Jones* v. *Commissioner*, 20 T.C.M. 26; *Estate of Ginsberg* v. *Commissioner*, 17 T.C.M. 472; *Kaar* v. *Commissioner*, 16 T.C.M. 355; *Ellstrom* v. *Commissioner*, 14 T.C.M. 312, affirmed *per curiam*, 235 F. 2d 181 (C.A. 6); *Omelian* v. *Commissioner*, 12 T.C.M. 306; *Gem Jewelry Co., Inc.* v. *Commissioner*, 6 T.C.M. 11, 15, affirmed on other issues, 165 F. 2d 991 (C.A. 5), certiorari denied, 334 U.S. 846; *R. J. Darnell, Inc.* v. *Commissioner*, 18 B.T.A. 125, affirmed, 60 F. 2d 82 (C.A. 6); *Boston Oldsmobile Co.* v. *Commissioner*, 16 B.T.A. 114; *Sells Lumber & Mfg. Co.* v. *Commissioner*, 14 B.T.A. 96, affirmed, 41 F. 2d 363 (C.A. 6); *Steiner Tire Co.* v. *Commissioner*, 9 B.T.A. 1289; *Ideal Reversible Hinge Co.* v. *Commissioner*, 7 B.T.A. 1066; *True* v. *Commissioner*, 6 B.T.A. 1042; *Appeal of Adams Motor Co.*, 4 B.T.A. 589, 595; *Appeal of Louis Allen*, 2 B.T.A. 1313; *Appeal of Alexander Reid & Co.*, 2 B.T.A. 425; *Appeal of Orkin Bros.*, 2 B.T.A. 65.

of diminished demand, petitioner would require the Court not only to invalidate Section 1.471-2(f)(1) of the Regulations but also to disapprove a body of case law that extends back even prior to the promulgation of T.D. 3296 in 1922.

b. *Section 1.471-2(f)(2)*. Petitioner wrote down parts of its inventory by 50 percent, by 75 percent, and even by 100 percent, while continuing to offer the items in that inventory for sale at unreduced prices. Such a practice was likewise disapproved by Section 1.471-2(f)(2) of the Regulations. That provision prohibits "[t]aking * * * other parts of the inventory, at a nominal price or at less than its proper value." The soundness of the Commissioner's disapproval in this respect is demonstrated by his allowance of the $245,000 write-down with respect to parts for unsuccessful products that petitioner sold at reduced prices. Petitioner's price reductions and subsequent sale

within a short period of time of these reduced-price items constituted objective evidence that its write-down did not result in a closing inventory figure at less than proper value. But with respect to parts offered and sold at unreduced prices, it is plain that petitioner's greatly reduced inventory prices were " 'nominal' " or " 'less than * * * proper value.' " *Fruehauf Trailer Co.* v. *Commissioner,* 42 T.C. 83, 99, affirmed, 356 F.2d 975 (C.A. 6), certiorari denied, 385 U.S. 822. Petitioner's write-downs are therefore disapproved by Section 1.471-2(f)(2) of the Regulations.

c. *Section 1.471-2(f)(3).* Since petitioner wrote down some of its inventory by 100 percent while retaining the goods in stock and offering them for sale at unreduced prices, its practice was also disapproved by Section 1.471-2(f)(3) of the Regulations. The 100 percent reduction was tantamount to "[o]mitting portions of the stock on hand." When inventory was worthless and was scrapped, the Commissioner permitted a write-down of $2,750,000 since petitioner no longer held those items for sale. But the Regulations prohibit omitting items from inventory by writing them down to zero, while at the same time retaining them and offering them for sale at unreduced prices. To this extent, petitioner's write-downs are barred by Section 1.471-2(f)(3).

The matter is therefore not, as petitioner would have it (Br. 20-21, 23, 61-64), that the Commissioner disapproved its inventory practices because they were not specifically approved by the Regulations. To the contrary, petitioner's write-downs are specifically disapproved by Section 1.471-2(f)(1)-(3) of the Regulations and by a large body of case law to the same effect.[21]

5. Petitioner further argues (Br. 21, 64, 66-68) that its write-downs of estimated excess inventory are supported by Section 1.471-2(c) of the Regulations. That provision states:

> Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used * * *. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

Both the Tax Court (Pet. App. A-27 to A-28) and the court of appeals (Pet. App. A-42) correctly held this provision to be inapplicable to petitioner's claimed write-down because its excess inventory was not physi-

[21] Petitioner virtually ignores the proscriptions of Section 1.471-2(f) of the Regulations. Indeed, its only reference (Br. 45 n.*) to the provision is to Section 1.471-2(f)(4), one of the two disapproved methods that does not describe petitioner's practice.

cally distinguishable from other units of inventory, *i.e.*, all of its tool parts and accessories were in essentially the same condition, and were commingled and interchangeable. Petitioner therefore failed to carry the burden imposed upon it by the Regulation of proving that its excess parts and accessories were unsalable at normal prices or unusable in the normal way "because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes." See *Cleveland Automobile Co.* v. *United States,* 70 F. 2d 365 (C.A. 6), certiorari denied, 293 U.S. 563; *D. Loveman & Son Export Corp.* v. *Commissioner,* 34 T.C. 776, 799–800, affirmed *per curiam,* 296 F. 2d 732 (C.A. 6), certiorari denied, 369 U.S. 860.

But whether or not the decision below was correct in so holding, Section 1.471–2(c) of the Regulations nevertheless offers no support to petitioner. It permits an inventory write-down only to "bona fide selling prices less direct cost of disposition," and defines the term "bona fide selling price" as an "actual offering of goods during a period ending not later than 30 days after inventory date." Moreover, the Regulation further requires the taxpayer to "maintain such records of the disposition of the goods as will enable a verification of the inventory to be made." Here, petitioner does not dispute (Br. 10, 68) that it did not reduce the offering or sale price of those items of inventory with respect to which the write-downs were disallowed within the 30-day period as required by the Regulations. Indeed, petitioner

never reduced its offering price with respect to such items but continued to hold them for sale at their original prices. There is accordingly no basis in Section 1.471–2(c) for petitioner's claimed write-down from cost to net realizable value. As the court of appeals correctly observed (Pet. App. A–43), petitioner cannot " 'substitute for the actual selling price required by the regulation a suppositious selling price which the Commissioner and the court must accept because it conforms to good accounting practice,' " quoting from *Cleveland Automobile Co.* v. *United States, supra,* 70 F. 2d at 369. Accord: *John L. Ashe, Inc.* v. *Commissioner,* 214 F.2d 13; *Pierce-Arrow Motor Car Co.* v. *United States,* 11 F. Supp. 60 (Ct. Cl.); *D. Loveman & Son Export Corp.* v. *Commissioner, supra; Boston Oldsmobile Co.* v. *Commissioner,* 16 B.T.A. 114; *Appeal of Otto A. Altschul,* 5 B.T.A. 53; *Appeal of Farmers' Hardware Co.,* 2 B.T.A. 90.[22]

[22] *Lucker* v. *United States*, 53 F. 2d 418 (Ct. Cl.), and *Superior Motor Parts Co.* v. *Commissioner*, 8 B.T.A. 407, upon which petitioner relies (Br. 42, 55), are not to the contrary. They each involved obsolete merchandise and are therefore consistent with the Commissioner's action in this case. See *Knowlton Bros.* v. *United States*, 53 F. Supp. 221 (Ct. Cl.) where the taxpayer claimed a stock of merchandise was obsolete, but continued to hold it for sale. In those circumstances, the Court of Claims denied the claimed write-down.

Petitioner's reliance (Br. 42–43) on *Fides Publishers Assn.* v. *United States*, 263 F. Supp. 924 (N.D. Ind.), and *Lord Motor Car Co.* v. *Commissioner*, 5 B.T.A. 818, acq. VI–2 Cum. Bull. 4, is similarly misplaced. In *Fides Publishers Assn.*, the government conceded that the taxpayer was entitled to an inventory write-down based upon future unsalability of some of its volumes in stock. The only question resolved by the court was whether the use of a two-year sales period for the books in question was proper

6. Moreover petitioner's claimed inventory write-down does not come within the terms of Section 1.471-4 of the Regulations which governs "[i]nventories at cost or market, whichever is lower," the method by which petitioner purported to value its inventories. As we have noted (*supra*, p. 32, n. 5), the lower of cost or market method was approved by an Opinion of the Attorney General in 1918, and has been sanctioned by Treasury Regulations since that time. The lower of cost or market method is to some extent a departure from normal rules insofar as it permits a deduction for a loss not yet completely realized. See *Sharp* v. *Commissioner*, 224 F. 2d 920, 924 (C.A. 6); *Space Controls, Inc.* v. *Commissioner*, 322 F. 2d 144, 148 (C.A. 5). The Regulations, however, strictly confine this departure within objectively determinable standards of actual pricing, and do not leave the determination of market to the imprecise standards applicable to other valuation disputes.

a. Section 1.471-4(a) of the Regulations sets forth the standard for "market" as follows:

> (a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of

(see 263 F. Supp. at 936). However, the court did not address the requirement of Section 1.471-2(c) that the taxpayer prove unsalability by reference to an actual offering of the goods during a period ending not later than 30 days after the inventory date.

In *Lord Motor Car Co.*, the taxpayer proved that the cost of disposition of its used cars was at least 25 percent of their sales price. The court therefore permitted a write-down under the predecessor of Section 1.471-2(c) of the Regulations which is applicable to "second-hand goods taken in exchange."

> the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—
>
> (1) Of goods purchased and on hand, and
>
> (2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; * * *.

As Judge Raum explained in *D. Loveman & Son Export Corp.* v. *Commissioner, supra*, 34 T.C. at 796, "the term 'market,' in the phrase 'lower of cost or market,' means the price which petitioners would have had to pay to replace items in their inventories on the applicable inventory dates. Conversely, it does not mean the price at which such merchandise is resold or offered for resale." Accord: *Pierce-Aroow Motor Car Co.* v. *United States, supra*; *Elder Mfg. Co.* v. *United States*, 10 F. Supp. 125 (ct. cl.); *Bedford Mills, Inc.* v. *United States, supra*.[23] The correctness of this construction of the term "market" is confirmed by the provision in the Regulations stating that " 'market' means the current *bid price* prevailing at the date of the inventory for the particular merchandise in the volume in which usually *purchased* by the taxpayer * * *" (emphasis supplied).

In other words, the term "market" as used in the Regulations and as uniformly construed by the courts, looks precisely in the opposite direction from petitioner's "net realizable value," by which it estimated the aggregate amount to be realized upon the future sale of its inventory.

[23] Differences between "replacement" and "reproductive" cost are not significant in this case. See 2 Mertens, *supra*, at § 16.22.

The disparity between the Regulations and petitioner's practice is further demonstrated by Section 1.471-4(c) of the Regulations, which requires that each item of inventory under the lower of cost or market method be valued, as opposed to an estimate of the yield of the aggregate. It provides:

> (c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article.

The decision below properly concluded that petitioner failed to comply with the requirements of this provision of the Regulations. As the Tax Court noted (Pet. App. A-26), petitioner "did not compare the replacement market value of each item with its cost to determine which was lower. Instead, it wrote down the value of the entire inventory applying arbitrary percentages" based upon its estimates of "ultimate salability." But as we have pointed out *supra*, p. 48, such an inventory valuation procedure is entirely within the uncontrolled discretion of the taxpayer and therefore bears no relationship to the objectively verifiable lower of cost or market method specified in the Regulations. The Tax Court therefore correctly concluded: "If we were to approve a concept permitting a write-down of inventory based upon an otherwise unsupported opinion of the taxpayer as to its ultimate salability we would, within some unknown limits, permit the taxpayer to determine how much tax it wanted to pay for a given year" (Pet. App. A-26).

b. Finally, petitioner relies (Br. 64-66) upon Section 1.471-4(b) of the Regulations. That provision addresses two special cases that differ from the "ordinary circumstances" discussed in paragraph (a). The two special cases are (1) "[w]here no open market exists or where quotations are nominal, due to inactive market conditions" and (2) "[w]here the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined." In each instance, recorded prices or offers of sale are to be determinative of market. In the first case, the Regulation requires "such evidence of a fair market price at the date * * * such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith." In the second case, where the taxpayer has offered merchandise at prices lower than current, "the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory."

The court of appeals rejected the applicability of paragraph (b) on the ground that petitioner's excess inventory did not fall within either of the two special cases addressed by that provision. Indeed, petitioner's president conceded that "'any business which is involved in the manufacture and sale of products inevitably must have excess inventory'" since the cost to produce additional goods that may be needed is marginal and would be prohibitive in the future (Pet. App. A-43 to A-44). But even on the assumption that

the excess inventory takes this case out of the "ordinary circumstances" of paragraph (a), there is nothing in the record that demonstrates the propriety of petitioner's inventory write-downs under Section 1.471–4(b). Rather, the evidence, such as it exists, indicates that the write-downs were improper by the standard of that paragraph. Petitioner may have correctly estimated that its inventory was larger than would be required over a period of time in the future but there was an active and steady market for the parts and products that it did not scrap as obsolete. Moreover, petitioner's percentage write-downs assumed the existence and continuation of such a market for at least a year, since it carried at full value a quantity of each item equal to the preceding year's sales. It therefore cannot be said that no open market existed for petitioner's spare parts. But even if there were an open market for these goods, Section 1.471–4(b) would still not justify the write-downs at issue because petitioner continued to sell the items in its inventory at unreduced prices.

The second case addressed by paragraph (b), where the taxpayer offers the goods at prices less than current, is likewise inapplicable. Furthermore, even if it were applicable, Section 1.471–4(b) makes actual prices and actual offers for sale determinative of "market." The closing sentence of the paragraph reads: "Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market." Here, petitioner acknowledges (Br. 10. 68) that the actual prices at which it sold its parts

and accessories remained unchanged and far above its written-down inventory valuations. Section 1.471–4(b) therefore demonstrates the correctness of the Commissioner's disallowance of its $926,952 reduction of its closing 1964 inventory.

7. Contrary to petitioner's further argument (Br. 38–40), nothing in either *Space Controls, Inc.* v. *Commissioner, supra,* or *E. W. Bliss Co.* v. *United States,* 224 F. Supp. 374 (N.D. Ohio), affirmed *per curiam,* 351 F. 2d 449 (C.A. 6), supports its claimed write-downs of inventory it estimated to be in excess of future customer demand.

In *Space Controls,* the taxpayer manufactured military trailers under a government contract. It was stipulated that neither the materials nor the finished trailers were suitable for sale to or use by any one other than the government. After it became apparent that the taxpayer's cost of materials and work-in-process exceeded the price per unit at which it was bound to sell to the government, it wrote down its inventory by the difference under the lower cost or market method.

On these facts, the Fifth Circuit held that the write-down was authorized by Section 1.471–4(b) of the Regulations because the taxpayer's market for the goods was completely restricted and it was contractually bound to sell them to the government at a fixed price. In so holding, the court concluded (322 F. 2d at 151) that the particularized facts of the case fit within the second situation described in Section 1.471–4(b): "'Where the taxpayer in the regular course of business has offered for sale such merchandise at

prices lower than the current price * * *, the inventory may be valued at such prices * * *, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory * * *.'"

Here, however, petitioner's market for its spare parts was not restricted by a fixed price contract nor did petitioner offer such parts for sale at reduced prices. To the contrary, it continued to offer them for sale at their original prices. Thus, unlike the taxpayer in *Space Controls,* petitioner cannot invoke the provisions of Section 1.471-4(b) of the Regulations.

E. W. Bliss Co. is similarly distinguishable. There, the taxpayer manufactured and sold large machinery on a custom basis under fixed price contracts in accordance with orders and specifications furnished by its customers. If the projected cost of a completed machine exceeded a certain percentage of the sale price thereby indicating a decreased profit or a loss, the taxpayer wrote down its inventory to reflect this decrease under the lower of cost or market method. On these facts, the court partially upheld the taxpayer's claimed inventory write-downs with respect to those contracts that were projected to result in a loss (224 F. Supp. at 379, 384).[24] As in *Space Controls,*

[24] The court disallowed the write-downs with respect to those contracts that would not produce a loss on the authority of Section 1.471-4(a)(2) of the Regulations, which excludes from the lower of cost or market method goods in process of manufacture and finished goods on hand "for delivery upon firm sales contracts * * * under which the taxpayer is protected against actual loss * * *." The Regulation specifies that such items must be inventoried at cost.

the court premised its decision on the authority of Section 1.471-4(b) of the Regulations permitting the write-down of inventories under the lower of cost or market method to actual prices "[w]here no open market exists * * *." The court stated: "It is obvious that there can be no open market for a partially finished press built to specifications of a particular purchaser who is bound by a firm contract to accept and pay a stipulated price for the press when completed and delivered" (224 F. Supp. at 379). However, petitioner's spare parts do not meet this description. They were neither subject to fixed price contracts nor built to the specifications of a particular purchaser. Nor were they offered for sale at reduced prices conforming to petitioner's inventory write-downs. Since the decision in *E. W. Bliss Co.* turns upon Section 1.471-4(b) of the Regulations, which is inapplicable in this case (see pp. 51-53, *supra*), it lends no support to petitioner's claimed write-downs.[25]

[25] *Monfort of Colorado, Inc.* v. *United States*, 561 F.2d 190 (C.A. 10); *Van Pickerill & Sons, Inc.* v. *United States*, 445 F. 2d 918 (C.A. 7); and *C-O-Two Fire Equipment Co.* v. *Commissioner*, 219 F. 2d 57 (C.A. 3), upon which petitioner relies (Br. 40-41, 53), are also distinguishable. *Monfort* did not involve a question of inventory valuation but whether a cattle finisher (one who buys cattle and fattens them in feedlots) could include the gains and losses from its hedging operations in the grain and cattle markets in its feed and cattle inventories, rather than reporting them separately.

Van Pickerill likewise did not involve inventory valuation. There, the court held that a liquor distributor's state tax and storage expenses could be currently deducted rather than added to its cost of goods sold and thereby deferred until the liquor was sold. In *C-O-Two Fire Equipment Co.*, it was undisputed that the taxpayer's inventory became obsolete. The sole question was whether it did so in 1946 or 1947.

In sum, the controlling Regulations require that a taxpayer employing the lower of cost or market inventory method must compute "market" value as replacement or reproduction cost unless: (1) the goods are unsalable at normal prices because of damage or obsolescence, (2) no open market exists for the goods, or (3) the taxpayer in the regular course of business has offered such goods for sale at prices lower than cost. In each of the three exceptions, the Regulations provide that the correctness of any inventory write-down from cost will be determined on the basis of either actual offers of sale or sales by the taxpayer that are proximate to the date of the inventory. Here, petitioner has simply written down its inventory of spare parts by $926,952 on the basis of its estimates that the quantities on hand exceed future demand while continuing to hold such parts for sale at their original prices. However, the Regulations explicitly prohibit the reduction of inventories without objective evidence of the accuracy of the taxpayer's valuation. The fact that petitioner continued to hold for sale and sell its spare parts at their original prices objectively demonstrates the impropriety of its write-down.

Petitioner nevertheless complains (Br. 25) that its inability to write down its purportedly excess inventory until it is scrapped or offered for sale at reduced prices leaves it with an "unattractive Hobson's choice: either the unsalable inventory must be carried for years at its cost instead of net realizable value, thereby overstating taxable income by such over-

valuation until it is scrapped, or the excess inventory must be scrapped prematurely to the detriment of the manufacturer and its customers" (*ibid.*). But petitioner has exactly the same choice open to every taxpayer owning business property that may have changed in value after acquisition. It may sell, exchange, or otherwise dispose of the property and thereby establish the fact and measure of its gain or loss. Or it may retain the property subject to further market fluctuations and establish the fact and measure of its possibly different gain or loss in some later year. It cannot, as petitioner seeks to do by means of its write-down, have it both ways by claiming a current loss based upon its subjective estimates of value while continuing to hold the property for sale at its original prices.

Indeed, to permit petitioner's claimed inventory write-down would violate the fundamental principle of our income tax system that a deductible loss must be established by a closed and completed transaction, fixed by identifiable events, and not by fluctuations in value. See Treasury Regulations, Section 1.165-1(b). *Boehm* v. *Commissioner,* 326 U.S. 287; *United States* v. *White Dental Co.,* 274 U.S. 398; *Reporter Publishing Co.* v. *Commissioner,* 201 F. 2d 743 (C.A. 10), certiorari denied, 345 U.S. 993. Cf. *Atlanta Biltmore Hotel Corp.* v. *Commissioner,* 349 F. 2d 677, 680-682 (C.A. 5). It may well be that systems of accounting sanctioned or enforced by other bodies, and for other purposes, may require information concerning current or fluctuating values. But those considerations play a carefully restricted role in the income tax pro-

visions of the Internal Revenue Code, and in the accounting systems upon which its administration is based. If the use of "market" in the lower of cost or market method of inventories moves slightly away from the closed transaction rules that predominate in the Internal Revenue Code, the movement is limited and strictly controlled by the Regulations. It does not encompass the uncontrolled accounting autonomy of its own estimates demanded by petitioner, that would, as the Tax Court concluded, "permit [it] to determine how much tax it wanted to pay for a given year" (Pet. App. A-26).

C. THE DECISIONS OF THIS COURT ESTABLISH THAT GENERALLY ACCEPTED COMMERCIAL ACCOUNTING PRACTICES THAT PERMIT RESERVES FOR ESTIMATED FUTURE EXPENSES OR LOSSES ARE NOT CONTROLLING FOR PURPOSES OF COMPUTING THE FEDERAL TAX LIABILITY ON CURRENT INCOME

1. In Section 212(b) of the Revenue Act of 1918, Congress for the first time [26] enacted explicit instructions with respect to the accounting methods of individual taxpayers.[27] The statute provided:

[26] Section 8(g) of the Revenue Act of 1916, 39 Stat. 763, had provided:

"Sec. 8. * * *

"(g) An individual keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect his income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make his return upon the basis upon which his accounts are kept, in which case the tax shall be computed upon his income as so returned."

Section 13(d) contained a similar provision with respect to corporate taxpayers.

[27] Section 232 made these provisions applicable also to corporations.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made upon such basis and in such manner as in the opinion of the Commissioner does clearly reflect the income.

These provisions have been carried forward through intervening enactments in substantially identical form and now appear as Section 446(a) and (b) of the 1954 Code, Appendix, *infra*, pp. 77–78. In Section 446 (c) of the 1954 Code, Congress enumerated, for the first time, the permissible overall methods of accounting, subject to the provisions of subsections (a) and (b). In 1954, Congress also added Section 446(e), which provides that "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the [Commissioner]."

In enacting this provision, the responsible committees explained that "Subsection (e) codifies existing regulations" and that a change in the method of accounting not only includes a change in the general method of accounting, but "also includes a change in the treatment of a material item such as a change in the method of valuing inventory, * * *." H.R. Rep.

No. 1337, 83d Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954).

2. If, as we submit, petitioner's write-downs of inventories to its estimates of "net realizable values" conflicts with the provisions of the controlling and long-standing Treasury Regulations, its claim (Br. 28–61) to conformity with generally accepted accounting is of little relevance. An unbroken line of decisions of this Court establishes that generally accepted commercial accounting practices do not govern the computation of federal income tax liability. *Lucas* v. *American Code Co., supra; Lucas* v. *Structural Steel Co., supra; Brown* v. *Helvering, supra,* 291 U.S. at 203–205; *Spring City Co.* v. *Commissioner,* 292 U.S. 182, 189–190; *Bazley* v. *Commissioner,* 331 U.S. 737, 741; *Automobile Club of Michigan* v. *Commissioner,* 353 U.S. 180, 188–190; *Commissioner* v. *Hansen,* 360 U.S. 446; *American Automobile Assn.* v. *United States,* 367 U.S. 687, 691–693 *Schlude* v. *Commissioner,* 372 U.S. 128; *United States* v. *Catto, supra,* 384 U.S. at 114.

Indeed, even accounting methods prescribed by federal regulatory agencies to insure compliance with other federal statutes are not determinative of tax liability under the Internal Revenue Code. *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, 562; *Mine Hill & Schuylkill Haven R. Co.* v. *Smith,* 184 F. 2d 422 (C.A. 3), certiorari denied, 340 U.S. 932; *Kansas City Southern R. Co.* v. *Commissioner,* 52 F. 2d 372, 378 (C.A. 8), certiorari denied, 284 U.S. 676. Cf. *Commissioner* v. *Idaho Power Co.,* 418 U.S. 1, 15.

The rationale underlying these authorities rests

upon the differing objectives of the revenue laws and commercial accounting practices. As evidenced by the provisions of Section 446 and its predecessors originating in the Revenue Act of 1918 (*supra,* pp. 58–60), the goal of the revenue laws is to measure net income in accordance with the requirements of an annual accounting system under a clear reflection of income standard. This means that unless specially authorized by statute, a taxpayer cannot currently deduct estimated losses or expenses that it anticipates will arise in the future beyond the close of the taxable year. However, a fair and accurate statement to creditors, shareholders, or prospective investors may take such anticipated losses into account in order to provide a broader and more conservative picture of the company's economic prospects over a period in excess of any one taxable year. See Finney and Miller, *Principles of Accounting, Intermediate* 381–390 (6th ed. 1965). Given the discrete objectives of commercial and tax accounting, the Court has consistently rejected attempts by taxpayers to reduce their taxable income by the use of reserves in anticipation of future losses. "The prudent business man often sets up reserves to cover contingent liabilities. But they are not allowable as deductions." *Lucas* v. *American Code Co., supra,* 280 U.S. at 452 (footnote omitted). Accord: *Brown* v. *Helvering, supra,* 291 U.S. at 202.

Here, too, petitioner's accountants may have properly concluded that its $926,952 write-down of purportedly excess inventory was required in order

to project a fair and conservative statement of its financial condition. But petitioner sustained no identifiable loss in the year of the write-down by either scrapping the items in question or offering them for sale at their reduced values. It therefore took no steps to confirm the accuracy of its estimated loss as required by the Regulations. Such an inventory reduction based upon estimates of an anticipated loss is nothing more than a reserve to cover a contingency that may arise in the future. Such a write-down cannot be taken into account in computing current tax liability. As the Court stated in *Weiss* v. *Wiener,* 279 U.S. 333, 335, "The income tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer." See also 2 Mertens, supra, §§ 12.67, 12.73.[28]

In this respect, the Court's decision in *American Automobile Assn.* v. *United States, supra,* is particularly instructive as to the subordinate role of generally accepted accounting practices in the computation of income tax liability. There, as here, "the record contain[ed] expert accounting testimony indicating that the [taxpayer's income-deferral method] was in accord with generally accepted accounting principles" (367 U.S. at 691) and the lower court

[28] Here, the inventory write-downs were made by new management with respect to a period governed by old management. Putting tax consideration aside, the inclination of new management in such a situation would be to reduce income for the prior period in order to enhance its own performance.

found this to be the fact (*id.* at 692). But this Court viewed such a finding and the expert testimony upon which it was based as "only to say that in performing the function of business accounting the method employed by the [taxpayer] 'is in accord with generally accepted commercial accounting principles and practices.' It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury" (*id.* at 693; footnote omitted). The Court concluded that while the taxpayer's accounting method "doubtless presents a rather accurate image of the total financial structure," it "fail[ed] to respect the criteria of annual tax accounting and may be rejected by the Commissioner" (*id.* at 692).

Finally, as the Court pointed out in *American Automobile Assn.,* in 1954 Congress briefly adopted provisions that would have permitted deferral of income as well as the deduction of anticipated expenses by the mechanism of reserves that petitioner seeks here. The Senate Finance Committee later explained that the purpose of these provisions (Sections 452 and 462 of the 1954 Code) was to bring "[t]ax accounting * * * more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses." S. Rep. No. 372, 84th Cong., 1st Sess. 3 (1955). But the change brought about by Sections 452 and 462 was short-lived, for less than a year later Congress repealed these provisions retroactively. While the taxpayer in *American Automobile Assn.* argued that Congress did not intend by the retro-

active repeal of these provisions to disturb prior law, the Court observed that "the cold fact is that it repealed the only law incontestably permitting the practice upon which the [taxpayer] depends" (367 U.S. at 695). In terms equally appropriate to this case, the Court characterized the retroactive repeal of Sections 452 and 462 as "a mandate from the Congress that petitioner's system was not acceptable for tax purposes. To interpret its careful consideration of the problem otherwise is to accuse the Congress of engaging in sciamachy" (*id.* at 695–696).[29]

[29] Petitioner attempts (Br. 44–46) to distinguish *American Automobile Assn.* on the ground that the deferral of prepaid income had never been allowed until the enactment of Section 452, which was retroactively repealed, while this case involves Section 471, which has remained unchanged for 50 years. But the clear reflection of income standard of Section 471, which petitioner studiously ignores, has likewise never permitted the establishment of reserves for anticipated inventory losses. However, the enactment of Section 462, which was also retroactively repealed, would have permitted reserves for known future expenses.

On the same day that the Court decided *American Automobile Assn.*, it granted certiorari in *Commissioner* v. *Milwaukee & Suburban Transport Corp.*, 367 U.S. 906, and remanded that case to the court of appeals for reconsideration in the light of *American Automobile Assn.* The court of appeals had allowed a reserve in that case (see 283 F. 2d 279). On remand, the court of appeals reversed its prior decision (see 293 F. 2d 628) and this Court denied certiorari (368 U.S. 976).

In support of its argument that the 1954 Code adopted generally accepted accounting principles as the determinants of taxable income, petitioner (Br. 29–31) cites Austin, Surrey, Warren and Winokur, *The Internal Revenue Code of 1954: Tax Accounting*, 68 Harv. L. Rev. 257 (1954). But this article, which understandably attributed great significance to Sections 452 and 462, was published in December 1954, six months prior to the retroactive repeal of those sections.

In sum, there is no basis for petitioner's contention that its inventory write-downs are entitled to a presumption that they clearly reflected its income because they conformed to generally accepted commercial accounting practices. Both the language of Sections 446 and 471, which has been extant for more than 50 years, and the decisions of this Court establish that the clear reflection of income standard is independent of commercial accounting considerations and that the Commissioner has wide latitude in determining whether a taxpayer's method of accounting clearly reflects its income. Indeed, after the retroactive repeal of Sections 452 and 462, the lower courts have consistently regarded as authoritative this Court's earlier decisions rejecting claimed deductions based upon reserves. See, *e.g.*, *Ertegun* v. *Commissioner*, 531 F. 2d 1156 (C.A. 2); *Portland Copper & Tank Works, Inc.* v. *Commissioner*, 351 F. 2d 460 (C.A. 1); *S. Garber, Inc.* v. *Commissioner*, 51 T.C. 733; *Juniata Farmers Cooperative Assn.* v. *Commissioner*, 43 T.C. 836, 841. If a new rule is to be fashioned, "[t]he validity of the long-established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case." *American Automobile Assn.* v. *United States*, *supra*, 367 U.S. at 697 (footnote omitted).

D. PETITIONER'S INVENTORY WRITE-DOWN CONSTITUTED A CHANGE OF ACCOUNTING METHOD REQUIRING THE PRIOR CONSENT OF THE COMMISSIONER UNDER SECTION 446(e) OF THE CODE

Even if petitioner's reduction in its 1964 closing inventory were permitted under Section 471 and the

controlling Treasury Regulations, its adoption constituted a change in accounting method which required the prior consent of the Commissioner under Section 446(e) of the Code. It is undisputed that petitioner did not seek and that the Commissioner did not give such consent (A. 22). Although neither the Tax Court nor the court of appeals reached this question (Pet. App. A-30, A-41 n. 12), the decision below that the Commissioner did not abuse his discretion in disallowing petitioner's adjustment to its 1964 closing inventory can be affirmed on this independent ground alone. See, *e.g., Dandridge* v. *Williams,* 397 U.S. 471, 475-476 n. 6; *LeTulle* v. *Scofield,* 308 U.S. 415; *Langnes* v. *Green,* 282 U.S. 531.

Section 446(e) provides that "a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate." As the Third Circuit explained in *Commissioner* v. *O. Liquidating Corp.,* 292 F. 2d 225, 230, the rationale for requiring the Commissioner's permission prior to implementation of a change of accounting method "is that virtually any material change in the method of reporting income or deduction items will result in a distortion of taxable income, and it is the Commissioner's responsibility to insure that the distortion will not be to the detriment of the Government. The Commissioner accomplishes this by withholding his consent until the taxpayer agrees to adjustments that will prevent, *inter*

alia, duplication of deduction items * * * as a result of the change." Thus, Section 446(e) provides an absolute rule requiring the prior consent of the Commissioner for a change of accounting method. Even if the change results in the clear reflection of income, the taxpayer's failure to secure prior consent for the change can result in disallowance.[30]

Treasury Regulations, Section 1.446-1(a)(1), defines "method of accounting" to include not only the overall method of accounting (*e.g.,* cash basis or accrual basis), but also the "accounting treatment of any item." Moreover, Section 1.446-1(e)(2)(ii)(c) of the Regulations provides: "A change in an overall plan or system of identifying or *valuing items in inventory* is a change in method of accounting. Also *a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting*" (emphasis added). Finally, Section 1.446-1(e)(2)(ii)(a) of the Regulations (Appendix, *infra,* pp. 83-84) defines a material item as "any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting in-

[30] The case law and the Regulations (Section 1.446-1(e)(2)(i)) both require that the taxpayer must seek and obtain the permission of the Commissioner prior to instituting a change in its method of accounting even if the method previously used by the taxpayer was erroneous as a matter of law or constituted an impermissible accounting practice. *Witte* v. *Commissioner,* 513 F. 2d 391 (C.A. D.C.); *Commissioner* v. *O. Liquidating Corp., supra; American Can Co.* v. *Commissioner,* 317 F. 2d 604 (C.A. 2); *Wright Contracting Co.* v. *Commissioner,* 316 F. 2d 249 (C.A. 5).

clude * * * a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder) * * *."[31] Accordingly, a change in the method of computing "market" value of inventory is the treatment of a material item for which the Commissioner's consent must be sought and obtained prior to the institution of the change. *Fruehauf Trailer Co.* v. *Commissioner, supra.*

Here, as the Tax Court found (Pet. App. A-10), petitioner's prior management carried its inventory at its full value, including those portions which the new management viewed to be in excess of anticipated market demand. In 1964, the new management priced the inventory under the prevailing standards and then

[31] The examples in the Regulations illustrating a change in a method of accounting which require the Commissioner's permission prior to implementation include the following (Section 1.446-1(e)(2)(c)(iii)):

"*Example* (7). A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a "reserve for price changes." Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations thereunder, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories."

"*Example* (8). A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories."

"began to adjust the inventory valuation, in order to show the inventory at its 'net realizable value,' * * *." (Pet. App. A-36). As the court of appeals stated (Pet. App. A-45), "[T]he new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years." Such a radical shift in inventory valuation is a change of accounting method requiring the prior consent of the Commissioner. It can hardly be doubted that the resulting $926,952 deduction would produce a distortion in taxable income requiring the Commissioner's examination to insure that proper adjustments are made.

Indeed, the record demonstrates that petitioner conceded that the inventory valuation method it adopted in 1964 was a change from the method it previously followed. The notes to petitioner's financial statements prepared for its 1964 annual report expressly acknowledge the changes that had occurred in 1964 (Ex. R, A. 247):

> The Accounts of the company at December 31, 1964 reflect certain changes from the accounting practices and principles previously followed. Changes were made in the methods of determining and valuing obsolete and excess inventory. * * *

In its report to the shareholders, petitioner similarly explained (Ex. P, A. 227): "A portion of the 1964 loss and, to a greater degree, of the extraordinary charge, resulted from changes in accounting practices and principles." Likewise, petitioner's Form 10-K submitted to the Securities and Exchange Commission on April 5, 1965, recognized that (Ex. R, A. 247-

248): "As of December 31, 1964 the company, under new management, revised its methods and procedures with respect to the determination of obsolete and excess quantities of inventories."

The fact that petitioner's expert witnesses testified that, in their opinion, the change in inventory valuation was a change in procedure rather than a change in accounting method and was required for financial accounting purposes is irrelevant in determining whether the Commissioner's permission to institute the change was required under Section 446(e). As we have pointed out *supra*, pp. 67–68, the Regulations and the case law provide that an accounting *procedure* that treats or affects a material item and is a consistently applied accounting practice is a "method of accounting" which requires the permission of the Commissioner in order to be changed. *O. Liquidating Corp., supra*, 292 F. 2d 225; *American Can Co.* v. *Commissioner*, 317 F. 2d 604 (C.A. 2); *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249 (C.A. 5); *Peoples Bank & Trust Co.* v. *Commissioner*, 415 F. 2d 1341 (C.A. 7). See also *John Wanamaker Philadelphia, Inc.* v. *United States*, 359 F. 2d 437, 441–442 (Ct. Cl.), where the court noted that generally accepted accounting principles are of little help in dealing with the year of the change where the change itself creates a distortion in income.

In sum, petitioner's adoption in 1964 of procedures to write-down its inventory to its "net realizable value" constituted a change in accounting method for which it was required to secure the prior consent of the Commissioner. Cf. *Willard Mfg. Co.* v. *Kennedy*,

109 F. 2d 83. Since petitioner concededly failed to obtain that consent, the Commissioner correctly disallowed its new method resulting in such write-downs.

II

THE COMMISSIONER PROPERLY EXERCISED HIS DISCRETION UNDER SECTION 166(c) OF THE CODE IN DETERMINING THE REASONABLE AMOUNT OF PETITIONER'S BAD DEBT RESERVE ON THE BASIS OF ITS PRIOR EXPERIENCE WITH RESPECT TO THE COLLECTION OF ACCOUNTS RECEIVABLE RATHER THAN ON THE BASIS OF ITS ESTIMATES OF COLLECTIBILITY

Under Section 166(a) of the Code, Appendix, *infra*, p. 77, a taxpayer may deduct each debt that becomes worthless within the taxable year under what is known as the specific charge-off method. Alternatively, an accrual basis taxpayer may elect to use the reserve method of accounting for bad debts authorized in Section 166(c). That subsection provides that "there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts." Under the reserve method, as specific debts become worthless they are deducted from the bad debt reserve. A "reasonable," and thereby deductible, addition to a bad debt reserve is the amount necessary to bring the balance in the reserve account to a level that can be reasonably expected to cover the losses anticipated with respect to debts outstanding at the end of the year. *Dixie Furniture Co.* v. *Commissioner*, 390 F. 2d 139 (C.A. 8).

In providing a limited exception to the general rule that anticipated or estimated losses are not deductible

(*Lucas* v. *American Code Co., supra*), Congress placed the use of the reserve for bad debts entirely within the discretion of the Commissioner. *Massachusetts Business Development Corp.* v. *Commissioner,* 52 T.C. 946, 951. Accordingly, it is well established that a determination by the Commissioner that a taxpayer's additions to its reserve are excessive must be upheld unless the taxpayer can establish that the Commissioner abused his discretion in reducing the claimed deductions. *Malone & Hyde, Inc.* v. *United States,* 568 F. 2d 474, 477 (C.A. 6); *First National Bank of Chicago* v. *Commissioner,* 546 F. 2d 759, 761 (C.A. 7); *Atlantic Discount Co.* v. *United States,* 473 F. 2d 412 (C.A. 5); *United States* v. *Haskel Engineering & Supply Co.,* 380 F. 2d 786, 789 (C.A. 9); *Paramount Finance Co.* v. *United States,* 304 F. 2d 460, 464 (Ct. Cl.).

Here, at the close of 1965, petitioner estimated the collectibility of each of its accounts. It set aside a 100 percent reserve for accounts it considered to be wholly uncollectible. It also applied the dollar ratio of uncollectible accounts to the total amount of accounts of more than $100 and applied this fraction to 90-day old accounts with a balance of less than $100. Moreover, petitioner established a flat two percent reserve for all other 90-day accounts and all accounts between 30 and 90 days past due. Finally, petitioner established a one percent reserve for all accounts less than 30 days old (Pet. App. A-47). These computations resulted in a total addition to petitioner's bad debt reserve of $135,150 (Pet. App. A-48).

Pursuant to his authority under Section 166(c), the Commissioner recomputed petitioner's bad debt reserve by applying the formula approved in *Black Motor Co.* v. *Commissioner,* 41 B.T.A. 300, affirmed on other grounds, 125 F. 2d 977 (C.A. 6). This formula measures the current addition to the bad debt reserve on the basis of the average annual losses from accounts receivable during the six-year period ending with the close of the taxable year (see 41 B.T.A. at 302). The *Black Motor Co.* formula yielded an addition to petitioner's bad debt reserve of $74,790.80 (Pet. App. A-48).

Petitioner challenges (Br. 74-76) the Commissioner's use of the *Black Motor* formula, asserting that its method of estimating the current collection potential of each class of accounts in accordance with their age is more accurate. However, the courts have consistently approved the *Black Motor Co.* formula as a "reasonable" method of computing a reserve for bad debts. See, *e.g., Atlantic Discount Co., Inc.* v. *United States, supra; Ehlen* v. *United States,* 323 F. 2d 535, 540 (Ct. Cl.); *S. W. Coe & Co.* v. *Dallman,* 216 F. 2d 566 (C.A. 7).

Moreover, petitioner did not come forward with any evidence that established that the Commissioner's use of the *Black Motor Co.* formula was an abuse of discretion. Petitioner introduced one exhibit (Ex. 18, A. 222) that simply showed how it computed its bad debt reserve and its accountants testified that its method was the preferred accounting practice. But the fact that a taxpayer's method of computing its

bad debt reserve is the preferred accounting practice does not establish an abuse of discretion by the Commissioner. *United States* v. *Haskel Engineering & Supply Co., supra; Calavo, Inc.* v. *Commissioner,* 304 F. 2d 650, 655 (C.A. 9). Petitioner did not show that conditions at the end of 1965 would make collection of accounts receivable less likely than in prior years.[32] Indeed, the Tax Court concluded from the entire record that collectibility was probably more likely at the end of 1965 than in prior years because of the advent of new management (Pet. App. A–32).[33] In short, petitioner did not prove that the Commissioner's method of determining its allowable bad debt reserve was in fact unreasonable.[34]

Rhode Island Hospital Trust Co. v. *Commissioner,* 29 F. 2d 339 (C.A. 1); *Calavo, Inc.* v. *Commissioner, supra;* and *Travis* v. *Commissioner,* 406 F. 2d 987 (C.A. 6), upon which petitioner relies (Br. 77–78),

[32] *Westchester Development Co.* v. *Commissioner*, 63 T.C. 198, acq. 1975–2 Cum. Bull. 2, upon which petitioner relies (Br. 75, 79), is therefore distinguishable. There, the Commissioner improperly included in the base period taxable years after the year in issue. Moreover, the taxpayer in that case showed that the base period was a "wholly unrepresentative period" in its history (63 T.C. at 212). Under these circumstances, the Tax Court held that the Commissioner had abused his discretion.

[33] From the end of 1964 to the end of 1965, petitioner's accounts receivable declined by approximately $1.4 million. However, its claimed bad debt reserve increased by $55,000 (Ex. Q, A. 239).

[34] Petitioner asserts (Br. 80) that during 1960–1963 its accounts receivable increased by 26.1 percent but that the chargeoffs by prior management decreased from 10 percent to 0.8 percent of the receivables. But such facts do not demonstrate that the six-year period ending at the close of 1965 was unrepresentative of petitioner's experience or that collectibility at the end of 1965 was less likely than in prior years.

are not to the contrary. In each of those cases, the courts reaffirmed the Commissioner's statutory discretion with respect to bad debt reserves. However, the taxpayers were able to demonstrate on the evidence that the Commissioner's recomputation of their bad debt reserve failed to consider all the facts and circumstances and thus constituted an abuse of discretion.[35] Here, on the other hand, petitioner failed to make that showing. On this record, the court of appeals therefore correctly concluded that "the Commissioner's method of determining the reserve for bad debts, which gave preference to experience over estimates, was reasonable" (Pet. App. A–48).[36]

[35] In *Rhode Island Hospital Trust Co.*, the court found that "unusual conditions" were present during the taxable year justifying the addition of $200,000 to the reserve and remanded the case to the Tax Court to test the reasonableness of another addition of $87,500, which had not been properly considered by the Commissioner. In *Travis*, the court found the Commissioner's determination "clearly erroneous" on the facts presented, which included a stipulation that the $31,618.22 in dispute was not collected, showing that there were particular collection problems with the dance studio contracts involved. In *Calavo, Inc.*, the Ninth Circuit held that the Commissioner had erroneously disregarded certain known factors affecting the collectibility of a specific debt and remanded the case to the Tax Court so that the Commissioner could give proper consideration to the particular circumstances in question.

[36] Petitioner's method of estimating uncollectible accounts receivable based on the length of time a debt has been outstanding is a technique commonly referred to as the "aging of receivables" (A. 120, 141, 167, 184–185). See Finney and Miller, *supra*, at 176. While use of the aging method gives an accurate portrayal of the estimated realizable value of the total accounts receivable for balance sheet purposes, it may fail to distribute losses to the proper periods. *Id.* at 176–177. See also *United States* v. *Haskel Engineering & Supply Co., supra*, where the court upheld the Commissioner's determination based on experience against the taxpayer's determination based on the "aging" method.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

WADE H. McCREE, JR.,
Solicitor General.

M. CARR FERGUSON,
Assistant Attorney General.

STUART A. SMITH,
Assistant to the Solicitor General.

ANN BELANGER DURNEY,
WILLIAM A. WHITLEDGE,
Attorneys.

AUGUST 1978.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 166. BAD DEBTS.

(a) *General Rule.*—

(1) *Wholly Worthless Debts.*—There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) *Partially Worthless Debts.*—When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(b) *Amount of Deduction.*—For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

(c) *Reserve for Bad Debts.*—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

* * * * *

SEC. 446. GENERAL RULE FOR METHODS OF ACCOUNTING.

(a) *General Rule.*—Taxable income shall be computed under the method of accounting on the

basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions.*—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c) *Permissible Methods.*—Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) the cash receipts and disbursements method;

(2) an accrual method;

(3) any other method permitted by this chapter; or

(4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary or his delegate.

(d) *Taxpayer Engaged in More Than One Business.*—A taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.

(e) *Requirement Respecting Change of Accounting Method.*—Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate.

Sec. 471. General Rule for Inventories.

Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.166-4 *Reserve for bad debts.*

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166-1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items.

(b) *Reasonableness of addition to reserve.*

(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.* A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

* * * * *

§ 1.446-1. *General rule for methods of accounting.*

(a) *General rule.*

(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term "method of accounting" includes not only the over-all

method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or busi-

ness will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

* * * * *

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section 6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in process, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see sections 471 and 472, and the regulations thereunder.)

* * * * *

(b) *Exceptions.*

(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

* * * * *

(e) *Requirement respecting the adoption or change of accounting method.*

* * * * *

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. A change in the method of accounting includes a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item. Consent must be secured whether or not a taxpayer regards the method from which he desires to change to be proper. Thus, a taxpayer may not compute his taxable income under a method of accounting different from that previously used by him unless such consent is secured.

(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent

treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder), a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451–3), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a change where the Internal Revenue Code and regulations thereunder specifically require that the consent of the Commissioner must be obtained before adopting such a change. [As amended by T.D. 7073, 1970–2 Cum. Bull. 98 (November 18, 1970), effective for taxable years beginning after December 31, 1953.]

* * * * *

§ 1.471–1. *Need for inventories.*

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. The inventory should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale, in which class fall containers, such as kegs, bottles, and cases,

whether returnable or not, if title thereto will pass to the purchaser of the product to be sold therein. **Merchandise should be included in the inventory only if title thereto is vested in the taxpayer. Accordingly, the seller should include in his inventory goods under contract for sale but not yet segregated and applied to the contract and goods out upon consignment, but should exclude from inventory goods sold (including containers), title to which has passed to the purchaser. A purchaser should include in inventory merchandise purchased (including containers), title to which has passed to him, although such merchandise is in transit or for other reasons has not been reduced to physical possession, but should not include goods ordered for future delivery, transfer of title to which has not yet been effected.**

§ 1.471–2. *Valuation of inventories.*

(a) Section 471 provides two tests to which each inventory must conform:

(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and

(2) It must clearly reflect the income.

(b) It follows, therefore, that inventory rules cannot be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. In order clearly to reflect income, the inventory practice of a taxpayer should be consistent from year to year, and greater weight is to be given to consistency than to any particular method of inventorying or basis of valuation so long as the method or basis used is substantially in accord with §§ 1.471–1 through 1.471–9. An inventory that can be used under the best accounting practice in a balance sheet showing the finan-

cial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income.

(c) The bases of valuation most commonly used by business concerns and which meet the requirements of section 471 are (1) cost and (2) cost or market, whichever is lower. (For inventories by dealers in securities, see § 1.471–5.) Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second-hand goods taken in exchange, should be valued at bona fide selling prices less direct cost of disposition, whether subparagraph (1) or (2) of this paragraph is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they shall be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods, but in no case shall such value be less than the scrap value. Bona fide selling price means actual offering of goods during a period ending not later than 30 days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made.

* * * * *

(f) The following methods, among others, are sometimes used in taking or valuing inventories, but are not in accord with the regulations in this part:

(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.

(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.

(3) Omitting portions of the stock on hand.

(4) Using a constant price or nominal value for so-called normal quantity of materials or goods in stock.

(5) Including stock in transit, shipped either to or from the taxpayer, the title to which is not vested in the taxpayer.

§ 1.471–4. *Inventories at cost or market, whichever is lower.*

(a) Under ordinary circumstances and for normal goods in an inventory, "market" means the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer, and is applicable in the cases—

(1) Of goods purchased and on hand, and

(2) Of basic elements of cost (materials, labor, and burden) in goods in process of manufacture and in finished goods on hand; exclusive, however, of goods on hand or in process of manufacture for delivery upon firm sales contracts (i.e., those not legally subject to cancellation by either party) at fixed prices entered into before the date of the inventory, under which the taxpayer is protected against actual loss, which goods must be inventoried at cost.

(b) Where no open market exists or where quotations are nominal, due to inactive market

conditions, the taxpayer must use such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments. Where the taxpayer in the regular course of business has offered for sale such merchandise at prices lower than the current price as above defined, the inventory may be valued at such prices less direct cost of disposition, and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory. Prices which vary materially from the actual prices so ascertained will not be accepted as reflecting the market.

(c) Where the inventory is valued upon the basis of cost or market, whichever is lower, the market value of each article on hand at the inventory date shall be compared with the cost of the article, and the lower of such values shall be taken as the inventory value of the article. * * *

U.S. GOVERNMENT PRINTING OFFICE: 1978

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner,
Thor Power Tool Co.

Of Counsel:
MAYER, BROWN & PLATT.

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

INDEX

Cases

Statutes

Treasury Regulations

I.R.S. Rulings

Miscellaneous

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

I.

INVENTORY ISSUE*

Reduced to its elements, Respondent's argument is a syllogism that misconceives both the facts and law. As Respondent sees it, in 1964 Thor took a current writedown for a future inventory loss; it was a future loss because it was unrealized; therefore, Thor's 1964 income was not clearly reflected.

1. Respondent fundamentally misunderstands the nature of Thor's excess inventory writedown, which it describes repeatedly as an anticipation of, or a reserve for, a future loss

---

* Thor is aware that this Court views extended reply briefs with disfavor. Unfortunately Respondent's brief, which introduces a major new argument, and urges affirmance on the basis of issues not reached by the lower courts, requires a comprehensive reply (pp. 16-24 and 32-48) so as to fully advise this Court of the relevant facts and law.

(Resp.Br. 22-23, 26 (heading), 32, 41-42, 58 (heading), 61-62, 64 n.29). This characterization flies in the face of the Tax Court's finding that Thor's 1964 writedowns ". . . resulted in petitioner's stating the inventory in issue at its estimate of *current* net realizable value" (emphasis added) (Pet. A-15)—a finding based on the unanimous and uncontradicted testimony of the expert accounting witnesses.

2. Respondent does not attempt to evaluate either Thor's writedown, or the Commissioner's contention that excess inventory cannot be written down until it is scrapped or its selling price reduced ("scrapping rule"),[1] in terms of the plain requirements of §§ 446 and 471.

Section 446(a) requires taxable income to be ". . . computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." Can this straightforward requirement be nullified simply by asserting that the Commissioner has the authority under § 446(b) to determine, without explanation, that Thor's inventory procedures do not clearly reflect its income? Respondent identifies no standards by which the Commissioner is to make this determination (see Resp.Br. 36-37).

Apart from contending that inventory losses cannot be taken until they are "realized", nowhere does Respondent offer any explanation how Thor's writedown of excess inventory to net realizable value did not clearly reflect its 1964 income within the meaning of either § 446 or § 471. Nor does Respondent offer any illumination as to how income could be clearly reflected, as mandated by those sections, by carrying unsalable inventory year after year at cost instead of at its much lower estimated current realizable value. As the Fifth Circuit stated in *Space*

1. It is wholly unrealistic to require a taxpayer to try to sell the estimated excess portion of an item at scrap value while he simultaneously attempts to merchandise salable quantities at normal prices (see Pet.Br. 68 and A61-A62, A128-A130). Inasmuch as such dual pricing is an impossibility, to require it is tantamount to saying that no taxpayer can write down excess inventory until it is scrapped—wherefore the "scrapping rule".

Controls, Inc. v. *Commissioner,* 322 F.2d 144, 154 (5th Cir. 1963):

> ". . . it would hardly be a true reflection of the financial condition of that concern were its inventory of dedicated goods valued at an amount which it could never get."

Respondent likewise bypasses the key question of how the scrapping rule can fulfill the conjunctive requirement of § 471, binding on the Commissioner and taxpayer alike, that the taxpayer's inventory must conform to the best accounting practice in its trade or business. The scrapping rule *cannot constitute a best accounting practice* because it contravenes generally accepted accounting principles (see Pet.Br. 13, 55, 59-61, and testimony of the experts at A114, A130-A131, A133, A156, A158, A176, A192-A193, A195).

3. Instead of examining the language of the statute and the legislative intention, Respondent relies on the Treasury Regulations, which can do no more than implement the statutory intention.

Respondent's appeal to the Regulations is selective. Although the Regulations under § 446 and § 471 both embody the principle that a taxpayer's income "ordinarily" and "as a general rule" will be regarded as clearly reflected if its inventory procedure is consistent with generally accepted accounting principles and constitutes the best accounting practice, these presumptions are dismissed as inapplicable because they admit of exceptions (Resp.Br. 36, 40). We are not told what these exceptions are or how they apply to this case. Instead, Respondent turns to the ". . . detailed provisions of the Regulations upon which this case must ultimately turn" (Resp.Br. 38).

Respondent's construction of the detailed provisions of the inventory Regulations also is highly selective. Broad language of the Regulations that can be construed in conformity with the statutory intention is subordinated to mechanical provisions which Respondent reads literally and narrowly even though they are not directed to the problem of valuing excess inventory (Resp. Br. 45-53).

4. This uneven reading of the Regulations is reinforced by radically distilling from them, and by engrafting from non-inventory cases, the proposition that inventory losses cannot be deducted before they are realized (Resp.Br. 31-32, 48, 56, 57-58). This concept, which never before has been applied to the valuation of inventories by a taxpayer using the lower-of-cost-or-market inventory valuation basis, provides the theoretical foundation of Respondent's contention that excess inventory cannot be written down to net realizable value until it is scrapped, or at least until it is offered for sale at a price below its cost. The introduction of the concept of realization ignores the entire administrative and judicial history of inventory accounting for tax purposes and embodies a fundamental confusion between the concept of "income and loss" and that of "realization".

5. Overshadowing the misunderstanding of the nature of Thor's writedown, the subordination of the statutory intention to the skewed interpretation of the Regulations, and the interjection of the realization criterion, is a remarkable reliance by the Respondent on the discretion of the Commissioner. See *amicus* brief of the National Association of Manufacturers, pp. 4-5. Respondent asserts that to the extent Congress created any presumption whether income is clearly reflected,

> ". . . it is in favor of the Commissioner's judgment that a method of accounting does not clearly reflect income. That judgment can only be set aside if the taxpayer meets the 'heavy burden of proving that the Commisioner's action was plainly arbitrary.' " (Resp.Br. 36-37.)

In like manner, whether an inventory procedure conforms to the "best accounting practice in the trade or business" is not to be determined by the accounting profession, but is to be decided by the Commissioner (Resp.Br. 33). There is no mention in Respondent's brief of the standards by which the Commissioner is to make these difficult determinations other than by reference to the language of the Regulations—which Respondent treats as controlling even though their provisions were drafted without the problem of valuing excess inventory in mind.

6. In addition to its principal argument, Respondent asserts, for affirmance on alternative grounds, that at the end of 1964 Thor changed its "method of accounting" without the prior permission of the Commissioner as required by § 446(e) (Resp. Br. 65-71). The Tax Court rendered no decision on this complex issue (see Pet. A-41, n.12), after correctly ruling that the Commissioner had the burden of proof on it (A14, A19, A30-A32). Accordingly, if this Court determines that this issue is relevant and that further proceedings are necessary, at most remand rather than affirmance would be appropriate.

The record does not support Respondent's factual allegations, but even if they are treated as fully proven, such a change by Thor would not constitute a change in its "method of accounting" within the meaning of § 446(e). Thor's inventory *method* remained FIFO and standard cost, and its *basis of valuation* remained the lower-of-cost-or-market. Moreover, any such change did not, and could not, cause the omission of income or a double deduction (*e.g.*, a double increase in Thor's cost-of-goods-sold), which is the *sine qua non* of a change to be within the scope of § 446(e). Thus, remand is not appropriate either.

7. Respondent further argues that the excess inventory valuation procedures employed by Thor at the end of 1964 resulted in opening and closing inventory for that year being calculated on an inconsistent basis, so that a portion of the $927,000 writedown properly belonged in such prior years (Resp.Br. 19, 39 n.19).[2] By pretrial order, the Tax Court excluded evidence on this point from the initial trial (A14, A19), reserved it for future hearing if it became relevant (A207-A208), and

2. Respondent's brief, p. 19 and especially p. 39 n.19, contains serious factual errors. Contrary to what is stated, the Commissioner did not disallow Thor's 1964 excess inventory writedown because its opening and closing inventories were not valued on the same basis; that theory originated shortly before trial three years after the statutory notice of deficiency was issued (see A16, A20). The Tax Court did not find that Thor's opening and closing inventories were valued on a different basis; see the Seventh Circuit's opinion (Pet. A-41 n.12).

therefore made no finding on this issue (see Pet. A-41 n.12).[3] Accordingly, while this issue may be grounds for remand, it is not an alternative basis for affirmance.[4]

A. Respondent's Arguments are Based on Major Misconceptions of the Record

Again and again, Respondent asserts, without citation to the record, that Thor's writedown of excess inventory at the end of 1964 constituted an anticipation of a future loss (Resp.Br. 22-23, 26 (heading), 32, 41-42, 58 (heading), 61-62, 64 n.29). This is contrary to the Tax Court's finding that Thor's 1964 inventory procedures ". . . resulted in petitioner's stating the inventory in issue at its estimate of *current* net realizable value" (emphasis added) (Pet. A-15). The Tax Court's finding is sup-

3. As pointed out in Thor's initial brief (Pet.Br. 70-71), Thor's writedown of excess inventory in 1964 was based on management's discretionary judgment, so that according to both case law and the Commissioner's usual practice, it properly belongs in that taxable year.

4. Respondent raises the question whether the writ of certiorari in this case may have been improvidently granted because of representations in the *amicus* brief of the National Association of Manufacturers (reiterated in Thor's reply to the Government's brief in opposition to the Petition) as to the number of cases involving this inventory issue pending in the Tax Court and the Appellate Division of the Internal Revenue Service (Resp.Br. 26 n.13). Thor is informed by counsel for the NAM that the data on pending cases was obtained from a letter, dated January 18, 1978, to counsel from the Freedom of Information Branch of the Internal Revenue Service. The Service did not reveal the extraordinary circumstances that 374 docket numbers represented a single case.

It is unfortunate that Respondent did not obtain any data from the Internal Revenue Service as to the number of cases pending in the Audit Division, which Thor believes to be unusually numerous.

Regardless of the number of comparable cases now pending, thousands of incorporated and unincorporated manufacturers, wholesalers and retailers of service parts, who use the commonplace lower-of-cost-or-market basis of valuation, are faced with the problem of how to value excess inventory for Federal income tax purposes. According to data published in American Institute of Certified Public Accountants, Accounting Trends and Techniques 111 (1977), at least 40% of all businesses use this basis of valuation.

ported by the unanimous and uncontradicted testimony of the accounting witnesses that Thor's writedown represented a loss existing at the end of 1964 (see A98-A99, A114-A115, A128-A130, A140-A141, A155-A156, A162-A163, A173-A174, A176, A181-A182, A192-A194, especially the testimony of Mr. Weston quoted at Pet.Br. 55n**).

It is true that the loss in value of the excess inventory was both unrealized and estimated at the end of 1964. But neither of these factors transforms that existing loss into a future loss. A direct analogy is the ordinary situation where goods in an inventory are written down to "market" because their reproduction cost on the inventory date is less than their original cost. The inventory can be written down even though the loss is unrealized, and current reproduction cost usually must in part be estimated. This, as the expert testimony demonstrates, is quite different from a reserve for anticipated future price declines, prohibited by both financial and tax accounting (*e.g.*, A114-A115). No matter how accurate the estimate or how probable or impending the anticipated future price decline, no loss exists on the inventory date so it cannot be the basis of a writedown.

Thor's 1964 writedown of excess inventory was based on the then existing fact that a portion of its inventory exceeded foreseeable demand and therefore was unsalable except as scrap. Thor estimated the extent of this unsalability by comparing the quantities on hand of each of some 44,000 different items to the actual sales or production usage of that item during 1964. By this method, supplemented by certain percentage writedowns for nine categories of goods at two plants where usage data was inadequate, Thor objectively determined the extent of an existing but unrealized loss on the unsalable portion of each item of its inventory.[5]

5. Respondent's brief mistakenly states that Thor's primary writedown procedure for excess inventory was applied to inventory at

(Footnote continued on next page)

Respondent attempts to give substance to the scrapping rule by repeatedly stating that Thor had taken a writedown of $2,750,000 for obsolete inventory at the end of 1964,[6] which the Commissioner allowed because these goods were scrapped "soon after they were removed from its [Thor's] 1964 closing inventory" (Resp.Br. 6, 17, 30-31). This reflects a misunderstanding of the record, which seemingly originated with the opening statement by the Commissioner's trial counsel (Tr. 69-70), for which no supporting evidence was introduced. Unfortunately this unproven statement found its way into the Seventh Circuit's opinion (Pet. A-36). Thor's obsolete goods were gradually scrapped over a five- or six-year period: cumulatively 43% in 1965; 55% in 1966; 60% in 1967; 86% in 1968; and 98% in 1969.[7] The 1964 *excess* inventory was scrapped somewhat more slowly: cumulatively 12% in 1965; 28% in 1966; 28% in 1967; 51% in 1968; 65% in 1969; and 77% in 1970.[8] The record thus refutes Respondent's theory that the Commissioner allowed the writedown of *obsolete* inventory because those items were scrapped shortly after the close of the taxable year, but disallowed the writedown of *excess* inventory because such items were not promptly scrapped.

There is another common denominator between Thor's 1964 writeoffs of obsolete and excess inventory that undermines

(Footnote continued from preceding page.)
only two of its four plants, and that the supplementary percentage writedowns were applied at its other two plants (Resp.Br. 7). The primary formula was applied to the inventory at *all* of Thor's plants and branches. The supplementary percentage writedowns were used in addition to the primary writedowns for limited categories of inventory at two of Thor's four plants (Stip. A25-A26, A60-A61).

6. The correct amount of the obsolete inventory writedown was $1,603,000 (A53).

7. These percentages are derived by subtracting the scrappings of excess inventory (recorded in Ex. 17, A38, A218) from the gross scrappings of obsolete *and* excess inventory (recorded in Ex. 22, Tr. 166, A221). They are overstated because they assume that the only scrapping of obsolete inventory during these years was of stock that was obsolete at the end of 1964.

8. These percentages are understated for the reasons set forth in Pet.Br. 10n.

other arguments of Respondent. The writeoff of obsolete goods, like that of excess goods, was based on Thor's actual sales for 1964: if there was no demand that year for a particular item, it was treated as obsolete and written off (A53). Thus, except for differences of nomenclature, the writeoff of obsolete stock was based on the same procedure as the writeoff of excess goods. If, for example, at the end of 1964 Thor held 500 units each of Items A and B, and sold none of A and 8 units of B during that year, it would have written off all 500 of A as obsolete and 489 of B as excess (see Pet.Br. 8). The Commissioner would allow the entire 500 unit writeoff, but none of the 489 unit writeoff. Is this difference in terminology so decisive under the subnormal goods Regulations (§ 1.471-2(c)) as to permit the writeoff of obsolete but not of the excess inventory? (Compare Pet.Br. 66-68 with Resp.Br. 45-47.) And can it be fairly said that in 1964 Thor changed its method of accounting for excess but not for obsolete inventory? See discussion *infra* at 37-41.

B. Thor's Writedown of Excess Inventory, Unlike the Commissoner's Scrapping Rule, Conforms to Both Requirements of § 471

Respondent's brief treats § 471 as if the clear reflection of income was the only—or the dominant—requirement imposed by that section (*e.g.*, Resp.Br. 35). But the statutory language plainly establishes conformity to the "best accounting practice" as a separate and equal requirement. It was added as a separate requirement by a Senate amendment to the House version of the Revenue Bill of 1918 (see Pet.Br. 33). Floor debate on the Revenue Bill of 1921 reaffirmed it as a distinct test (Pet.Br. 33n***). Continuously since 1922,[9] the Regulations have ex-

9. See Pet.Br. 34.

plicitly recognized that the statute imposes two tests. Article 1582 of Regulations 45 provided in part:

> "The Act provides two tests to which each inventory must conform—(1) It must conform as nearly as may be to the best accounting practice in the trade or business, and (2) It must clearly reflect the income. It follows, therefore, that inventory rules can not be uniform but must give effect to trade customs which come within the scope of the best accounting practice in the particular trade or business. . . ."

Section 1.471-2(a) reads identically.

By deemphasizing the "best accounting practice" requirement, Respondent bypasses the troublesome fact that, according to the uncontradicted testimony of the accounting experts, the scrapping rule does not meet this requirement (*e.g.*, A130-A131, A156, A192-A193), whereas Thor's writedown procedures do, as the Tax Court found (Pet. A-15). Thus, in choosing between the Commissioner's scrapping rule and Thor's writedown procedures, only the latter can meet both explicit statutory requirements.

The question becomes whether Thor's writedown for excess inventory clearly reflected its income under § 471 (and under § 446). Thor showed in its initial brief that the case law, generally accepted accounting principles, and the public financial disclosure rules of the S.E.C. all lead to the conclusion that Thor's inventory writedown resulted in its income being clearly reflected for tax purposes (Pet.Br. 54-59). Respondent disputes this by arguing that generally accepted accounting principles "do not govern the computation of federal income tax liability" and that the "accounting methods prescribed by other federal regulatory agencies . . . are not determinative of tax liability" (Resp.Br. 60). But Respondent does not address the question of how generally accepted accounting principles or S.E.C. standards would distort Thor's income for tax purposes.

For over 50 years, from 1922 until after the trial of this case, the Regulations explicitly made the best accounting practice presumptively determinative of the clear reflection of income. Until 1973, Regulation § 1.471-2(b) provided:

> "An inventory that can be used under the best accounting practice in a balance sheet showing the financial position of the taxpayer can, as a general rule, be regarded as clearly reflecting his income."[10]

This presumption under § 471 echoes the presumption under the general tax accounting rules of § 446 (which remain in the Regulations, and which appeared virtually *in haec verba* in the explanation of § 446 in both the House and Senate Reports accompanying the 1954 Code) that if a taxpayer's accounting method conforms to generally accepted accounting principles, it ordinarily will clearly reflect income. See Pet.Br. 28-31.

Respondent argues that because these presumptions contain the phrases "ordinarily" and "as a general rule," they are subject to exceptions (Resp.Br. 36, 40). But Respondent offers no guidance as to what these "exceptions" are, under what circumstances they should override the presumptions, or how they are applicable to this case. Thor submits that these presumptions of the Regulations should apply unless the Commissioner can advance some reasonable explanation why in this case they should not.

In rejoinder, Respondent relies exclusively on the supremacy of the Commissioner's discretion to the point of reversing the presumption:

> ". . . to the extent that Congress created a presumption, it is in favor of the Commissioner's judgment that a method of accounting does not clearly reflect income. That judgment can only be set aside if the taxpayer meets the 'heavy burden of proving that the Commissioner's action was plainly arbitrary'." (Resp.Br. 36-37.)

This proposition is justified by citing *Lucas* v. *Kansas City Structural Steel Co.*, 281 U.S. 264, 271 (1930), involving the base stock inventory method which did not conform to generally accepted accounting principles and had been explicitly

10. This sentence was deleted without explanation from the Regulations in 1973 after trial of this case and long after the tax year here involved. See Pet.Br. 34-35 and 32n.

condemned by rulings and Regulations since 1919 (see Pet.Br. 45n). As Thor pointed out in its initial brief, no case has applied the "plainly arbitrary" standard in favor of the Commissioner where the taxpayer's accounting method and procedures conformed to generally accepted accounting principles (see Pet.Br. 51).

Respondent overlooks the fact that the courts, consistent with the presumption of § 1.471-2(b), quoted *supra* at 11, uniformly have held that inventory procedures that constituted the best accounting practice and conformed to generally accepted accounting principles do clearly reflect income. See Thor's initial brief (Pet.Br. 38-43), citing especially *E. W. Bliss Co.* v. *United States,* 351 F.2d 449 (6th Cir. 1965), *adopting the District Court's opinion,* 224 F.Supp. 374, 385 (N.D. Ohio 1963); *Space Controls, Inc.* v. *Commissioner,* 322 F.2d 144, 149 (5th Cir. 1963); and *Van Pickerill & Sons, Inc.* v. *United States,* 445 F.2d 918, 920-21 (7th Cir. 1971).[11] It is noteworthy that both *Space Controls,* 322 F.2d at 147, and *Bliss,* 224 F.Supp. at 379, involved *estimates of future costs* to determine an existing but unrealized loss (which Respondent concedes at least as to *Bliss,* Resp.Br. 54).

Respondent further argues that the presumptions of the Regulations cannot be read "so as to override other specific provisions of the Regulations" because that would "virtually render meaningless the detailed provisions of Sections 1.471-1 through 1.471-9 of the Regulations" (Resp.Br. 40).[12] This

11. Respondent seemingly misunderstands (Resp.Br. 53-55) the import of Thor's citation to those cases (Pet.Br. 38-43). Thor's point is that until the decisions below the Courts of Appeals for three Circuits and the Tax Court uniformly have held that income is clearly reflected if the taxpayer's inventory procedures conform to generally accepted accounting principles, regardless whether these procedures were explicitly authorized by the Regulations. Respondent attempts to distinguish those cases on their facts, but such factual differences are not relevant to Thor's thesis.

12. The specific provisions of the inventory Regulations can, by their very detail, create a conflict with the statutory requirement of best accounting practice. In commenting, at the request of the Com-

(Footnote continued on next page)

argument ignores that § 1.471-2(b), which articulates the presumption, requires only that a taxpayer's "method of inventorying or basis of valuation" be "substantially in accord" with the detailed provisions of the Regulations. But unless the detailed provisions of the Regulations are construed (see Pet. Br. 64-68) to permit Thor's writedown which constitutes the best accounting practice (and to prohibit the Commissioner's scrapping rule which does not), the Regulations in effect will nullify the plain statutory requirement that inventory procedures must constitute the best accounting practice. Regulations can only implement and interpret the statute, not render part of it meaningless. In explaining the relative roles of the statute and the Treasury Regulations, this Court stated in *Manhattan General Equip. Co.* v. *Commissioner,* 297 U.S. 129, 134-35 (1936):

> ". . . A regulation which . . . operates to create a rule out of harmony with the statute, is a mere nullity. . . . And not only must a regulation, in order to be valid, be consistent with the statute, but it must be reasonable. . . .
>
> ". . . The statute defines the rights of the taxpayer and fixes a standard by which such rights are to be measured. The regulation constitutes only a step in the administrative process. It does not, and could not, alter the statute."

See also *Helvering* v. *Credit Alliance Corp.,* 316 U.S. 107, 113 (1942); and *Koshland* v. *Helvering,* 298 U.S. 441, 447 (1936).

Independent of the supremacy of the statute, it is appropriate to accord less than usual significance to the detailed provisions of the Regulations where, as here, they were drafted without adequately covering the problem of valuing excess inventory.

(Footnote continued from preceding page.)

missioner, on the proposed (1973) amendments to the inventory Regulations under § 471, the Division of Federal Taxation of the A.I.C.P.A. observed (Ex. 29, A151, A223-A224):

> "It should also be noted that in attempting to achieve the objective of conforming tax and financial accounting, it is inconsistent for tax accounting rules to be spelled out in such great detail as is the case in these proposed regulations. This detail, in effect, promulgates new accounting principles rather than adopts generally accepted accounting principles, where applicable, for federal income tax purposes."

Respondent correctly asserts that the detailed provisions of the Regulations can be deemed to have legislative assent because of multiple reenactments of the Revenue Acts and subsequent codifications (Resp.Br. 37-38).[13] But it is a very large step to conclude that this legislative assent includes a prohibition of excess inventory writedowns because they were not explicitly covered by the Regulations. All the cases cited by Respondent in support of legislative assent construed regulations which resolved matters not fully covered by the statute.[14] None involved the situation where, as here, the Regulations failed to provide relevant guidance; where the Commissioner was aware for many years that the Regulations were inadequate but did nothing to resolve the problem (see Pet.Br. 63-64); and where for a number of years the Commissioner interpreted the Regulations to permit the writedown of excess inventory, and then, without any amendment of them (and in the absence of any judicial decision) commenced to disallow such writedowns. See Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude*, 23 N.Y.U. Institute on Federal Taxation 839, 850 (1965).

* * *

Thor submits that there can be no stronger case for giving effect to the statement long contained in the Regulations that generally accepted accounting principles will normally clearly reflect income than the present case, in which the evidence is undisputed that Thor's excess inventory writedown conformed to generally accepted accounting principles and no explanation has been given by the Commissioner as to why that writedown did not clearly reflect income. Respondent's argument that

13. Thor relies on the same rule to show legislative assent to the general provisions of the Regulations (Pet.Br. 35-37).

14. *Bingler* v. *Johnson*, 394 U.S. 741, 749-750 (1969); *Commissoner* v. *South Texas Lumber Co.*, 333 U.S. 496, 501 (1948); *Fulman* v. *United States*, 434 U.S. 528 (1978); *United States* v. *Correll*, 389 U.S. 299 (1967); *Helvering* v. *Winmill*, 305 U.S. 79 (1938); *Lykes* v. *United States*, 343 U.S. 118 (1952); *United States* v. *Catto*, 384 U.S. 102 (1966).

he has discretion to ignore the presumptions under both § 446 and § 471, and that their application conflicts with the detailed provisions of the inventory Regulations (which no one contends are specifically directed to the problem of valuing excess inventory), should be insufficient to nullify them. If the presumptions in favor of generally accepted accounting principles are not given effect here, and the Commissioner's scrapping rule is upheld, the best accounting practice requirement will in substance have been written out of the statute.

C. The Regulations Do Not Prohibit Thor's Writedown of Excess Inventory

Respondent's reliance on the supremacy of the Regulations is stated unequivocally (Resp.Br. 38): "We therefore turn to the detailed provisions of the Regulations upon which this case must ultimately turn." From this premise, Respondent argues that Thor's valuation procedures:

(i) are specifically prohibited by § 1.471-2(f);

(ii) are prohibited because they do not conform to the detailed rules of § 1.471-2(c) authorizing the writedown of subnormal goods or of § 1.471-4 governing the valuation of goods at the lower-of-cost-or-market; and

(iii) are inconsistent with the rationale of §§ 1.471-2(c) and 1.471-4, which can be interpreted to require that any writedown of goods be realized by scrapping, or at least confirmed by reducing the price at which the goods are offered for sale.

Respondent vacillates between insisting on a strict scrapping rule, or allowing price decreases as sufficient "objective" evidence. Compare Resp.Br. 57-58 with 48. The latter alternative is wholly unrealistic because it would require Thor to try to sell the estimated excess quantities of repair parts at scrap value while simultaneously attempting to merchandise salable

quantities at normal prices (see Pet.Br. 68 and A61-A62, A128-A130). To require dual pricing is tantamount to saying that no taxpayer can ever write down excess inventory until it is scrapped. The cases have not required such impracticality. See discussion *supra* at 25-26 and 28.

Despite its extended analysis of these regulatory provisions, Respondent's brief ignores the Commissioner's acknowledgment in Announcement 76-115, I.R.B. 1976-36, p. 16, and in Revenue Procedure 76-28, 1976-2 C.B. 645, 646, that *excess* inventory writedowns are possible under both the subnormal goods and market value Regulations (see Pet.Br. 69). This acknowledgment intimates that the Commissioner recognizes that inventory writedowns not specifically authorized by the Regulations may nonetheless be proper.

1. *Section 1.471-2(f) Is Not Intended to Prohibit Thor's Excess Inventory Writedown.* Respondent introduces an entirely new argument in this case by contending that any of three provisions of § 1.471-2(f) preclude Thor's writedown of excess inventory (Resp.Br. 40-45). Section 1.471-2(f) prohibits:

> "(1) Deducting from the inventory a reserve for price changes, or an estimated depreciation in the value thereof.
>
> "(2) Taking work in process, or other parts of the inventory, at a nominal price or at less than its proper value.
>
> "(3) Omitting portions of the stock on hand."

Not only is this argument novel to this case, but Thor cannot find any decision citing these prohibitions to invalidate an inventory method or procedure that conformed to generally accepted accounting principles or constituted a best accounting practice[15]. This novelty casts upon this argument the cloud

15. The narrow scope accorded these prohibitions may be gleaned from the fact that Thor can find only five cases in some 56 years that have cited § 1.471-2(f)(1) through (3) and its lineal predecessors: *Burton Coal & Lumber Co.*, 22 B.T.A. 133, 135 (1931) (taxpayer attempted to claim a deduction for estimated depreciation of merchandise); *S & R Chevrolet Co.* v. *Birmingham*, 93 F.Supp. 950, 962-63 (N.D. Iowa 1950) (summarized *infra* at 20 n.21); *Ralph Ellstrom*, 14 T.C.M.(CCH) 312, 317, P-H

(Footnote continued on next page)

that it is a "*post hoc* rationalization" of appellate counsel which this Court has rejected under the *Chenery* rule as an inadequate substitute for a sound reason for an administrative agency's actions. See *FPC* v. *Texaco Inc.*, 417 U.S. 380, 397 (1974), *citing SEC* v. *Chenery Corp.*, 332 U.S. 194, 196 (1947); *NLRB* v. *Pipefitters Local No. 638*, 429 U.S. 507, 522n. (1977). As such it should be given little or no weight.[16]

The prohibitions of § 1.471-2(f) first appeared in Article 1582 of the 1920 edition of Regulations 45, as amended by T.D. 3296 (approved March 3, 1922), I-1 C.B. 40 (1922), and can be traced in part to two major rulings of the Treasury Advisory Tax Board, T.B.R. 48, 1 C.B. 47 (1919) (prohibiting "average value" method in costing inventories), and T.B.R. 65, 1 C.B. 51 (1919) (prohibiting both the base stock method and reserves for inventory price fluctuations). These prohibitions were developed at a time when tax accounting was in its infancy, and the Treasury was confronted with the problem of identifying and prohibiting unsound inventory practices. They were immediately commended as consistent with accepted

(Footnote continued from preceding page.)

TC Mem.Dec. 55-260, 55-264 (1955), *aff'd per curiam*, 235 F.2d 181 (6th Cir. 1956) (summarized *infra* at 19 n.17); *Kenneth B. Kaar*, 16 T.C.M.(CCH) 355, 357, P-H TC Mem.Dec. 57-301, 57-303 (1957) (summarized *infra* at 19 n.18); *Ernest, Holdeman & Collet, Inc.*, 19 T.C.M.(CCH) 42, 50-51, P-H TC Mem. Dec. 60-43, 60-54 (1960), *aff'd on other grounds*, 290 F.2d 3 (7th Cir. 1961) (writedown of used machines sustained even though many were later sold at prices substantially in excess of taxpayer's valuation).

16. As the following discussion in the text demonstrates, Respondent attempts to apply § 1.471-2(f)(1)-(3) by analogy. Thor submits that it is not appropriate for this Court to decide in the first instance whether these provisions should be extended to cover inventory procedures that conform to generally accepted accounting principles. Taxpayers are entitled to rely with reasonable certitude on an established interpretation of the Regulations. A determination, in effect retroactive, that this Regulation has a scope much broader than its plainly intended purpose and prior application would violate that principle, particularly as there may be many accounting procedures now considered proper that may be somewhat analogous to those forbidden by § 1.471-2(f).

financial accounting principles by Robert H. Montgomery, then the leading commentator on tax accounting: "The five methods which are specifically disapproved [in Article 1582] are in themselves technical departures from good accounting practice." Montgomery, Income Tax Procedure 459 (1922 edition). This background supports the conclusion that none of these prohibitions were intended to apply to Thor's writedown of excess inventory, because it conformed to generally accepted accounting principles. The three prohibitions will be analyzed individually under (i), (ii) and (iii) below.

(i) Thor's excess inventory writedown at the end of 1964 was not equivalent to a "reserve for price changes, or an estimated depreciation in the value" of the inventory within the meaning of § 1.471-2(f)(1). As was shown earlier, *supra* at 6-7, Thor's writedown was for an existing loss, not an anticipated future loss. Expected price changes or other anticipated future depreciation simply were not involved at all.

Respondent's brief reflects its misunderstanding of the facts when it states that:

> "Given this explicit prohibition in the Regulations, it is hardly surprising that the courts have rejected such percentage write-downs of inventory, whether *the anticipation of diminished realization* arose from changes in styles or general price levels, excess supplies, supervening technology, disadvantageous changes in the geographic or business environment, or otherwise. [Footnote omitted.] In seeking write-downs based upon estimates of diminished demand, petitioner would require the Court not only to invalidate Section 1.471-2(f)(1) of the Regulations but also to disapprove a body of case law that extends back even prior to the promulgation of T.D. 3296 in 1922." (Emphasis added.) Resp.Br. 42-43.

Footnoting this passage, Respondent cites some 22 cases, none of which are factually similar to this case. All are distinguishable in one and sometimes several of the following major respects:

(a) accounting procedures explicitly prohibited by the Regulations;[17]

(b) hybrid methods of accounting prohibited prior to the 1954 Code;[18]

(c) percentage writedowns of an *entire* inventory because a *portion* of the inventory had declined in value;[19]

(d) valuation procedures that the court found did not conform to generally accepted accounting principles;[20]

(e) estimated percentage writedowns of an entire inventory or broad categories of it, which the trial court

17. *Western Dry Goods Co.* v. *United States,* 34 F.2d 976 (W.D. Wash. 1929) (valuation of inventory at "normal" cost, a variant of the prohibited base stock method); *Ralph Ellstrom,* 14 T.C.M.(CCH) 312, P-H TC Mem.Dec. 55-260 (1955), *aff'd per curiam,* 235 F.2d 181 (6th Cir. 1956) (valuation of inventory at flat rate to anticipate price changes).

18. *Boston Oldsmobile Co.,* 16 B.T.A. 114, 117-18 (1929), *acq.* IX-1 C.B. 6 (1930) (combination of cost and lower-of-cost-or-market methods); *Kenneth B. Kaar,* 16 T.C.M.(CCH) 355, 357, P-H TC Mem.Dec. 57-301, 57-303 (1957) (arbitrary formula which assumed that a majority of the inventory items were purchased for less than "present cost price"); *O. A. Steiner Tire Co.,* 9 B.T.A. 1289, 1291 (1928) (combination of cost and lower-of-cost-or-market methods).

19. *Adams Motor Co.,* 4 B.T.A. 589 (1926), *acq.* IV-1 C.B. 1 (1927) (deduction from total inventory based on estimate of decrease in value due to inclusion of obsolete items); *Gem Jewelry Co.,* 6 T.C.M.(CCH) 11, P-H TC Mem.Dec. 47-7 (1947), *aff'd on other issues,* 165 F.2d 991 (5th Cir. 1948), *cert. denied,* 334 U.S. 846 (1948) (blanket mark-down of 10% to cover shelf wear, outmoded fashions, market fluctuations and damage).

20. *Brooks-Massey Dodge, Inc.,* 60 T.C. 884, 894 (1973) (20% writedown of used cars below published wholesale prices was not a best accounting method); *Estate of Jones,* 20 T.C.M. (CCH) 26, 30, P-H TC Mem.Dec. 61-30, 61-34 (1961) (48% writedown of house trailers, including new models, was not in accordance with good accounting principles); *Wesley J. Rogers,* 20 T.C.M.(CCH) 1515, 1517, P-H TC Mem.Dec. 61-1657, 60-1659 (1961) (20% annual writedown of defunct variety store merchandise in storage improper because use of annual inventories is inappropriate where stock was not part of an ongoing business); *Leo J. Omelian,* 12 T.C.M.(CCH) 306, 309-10 P-H TC Mem.Dec. 53-296, 53-299 (1953) (novel formula for determining "cost").

expressly determined were unsupported either by current facts or later events.[21]

In sharp contrast to these decisions are a number of cases in which percentage formula writedowns were upheld because the trial court was convinced that the taxpayer had used *its best efforts to value the inventory with a reasonable degree of accuracy.* In *S. G. Sample Co.* v. *Commissioner,* 23 F.2d 671, 672 (5th Cir. 1928), *rev'g* 5 B.T.A. 1034 (1926), the Fifth Circuit held that the Board of Tax Appeals erred in not permitting a clothing retailer an opportunity to prove that a 25% average writedown of its inventory reflected market value. The Fifth Circuit concluded that there was no legal requirement that the taxpayer identify separately the amount of estimated market decline for each item in the inventory.[22]

21. *John E. Ashe, Inc.* v. *Commissioner,* 214 F.2d 13, 15 (5th Cir. 1954) (percentage writedowns of retail clothing store by items classified as good, fair or poor was "arbitrary"); *R. J. Darnell, Inc.,* 18 B.T.A. 125, 129 (1929), *aff'd,* 60 F.2d 82 (6th Cir. 1932) (evidence of market value found to be merely "conjectures or estimates"); *Sells Lumber & Mfg. Co.,* 14 B.T.A. 96, 103 (1928), *aff'd,* 41 F.2d 363 (6th Cir. 1930) (taxpayer did not establish amount of consigned merchandise still unsold and could not deduct from income unrealized profits thereon); *Ideal Reversible Hinge Co.,* 7 B.T.A. 1066 (1929) (replacement cost was more representative of market value than arbitrary "fair value" determined by taxpayer); *Harry P. True,* 6 B.T.A. 1042 (1927) (judgment of taxpayer not sufficient proof of market value); *Louis Allen,* 2 B.T.A. 1313 (1925), *acq.* V-1 C.B. 1 (1926) (taxpayer discounted all inventory by 2% of purchases for the purpose of reducing it from cost to actual market value); *Alexander Reid & Co.,* 2 B.T.A. 425 (1925) (taxpayer admitted reduction in inventory was an approximation); *Orkin Brothers,* 2 B.T.A. 65 (1925) (evidence "vague and indefinite"); *Saul S. Pearl,* 36 T.C.M.(CCH) 1059, 1065-66, P-H TC Mem.Dec. 77-1060, 77-1066-67 (1977) (items written down to scrap value later sold for prices up to 40 times that value); *Estate of Ginsberg,* 17 T.C.M.(CCH) 472, 481, P-H TC Mem.Dec. 58-406, 58-414 (1958), *aff'd on other issues,* 271 F.2d 511 (5th Cir. 1959) (evidence not sufficient to show writedown justified); *S & R Chevrolet Co.* v. *Birmingham,* 93 F.Supp. 950 (N.D. Iowa 1950) (many used cars against which a reserve was set up were later sold at substantial profits).

22. See also *May Lumber Co.,* 13 B.T.A. 62, 69 (1928) (writedowns, varying from year-to-year, of lumber for estimated deteriora-

(Footnote continued on next page)

Not one of the cases cited by Respondent or by Thor, including those which upheld the taxpayer's inventory procedure, involved a writedown procedure that was as objective and immune from manipulation as Thor's primary formula for writing down excess inventory.[23] Management, in fact, intended it to be such (A65). That formula was based on current sales and production usage, which Thor could not minimize to reduce inventory values without suffering greater and unacceptable economic detriment by lost sales. It was calculated on an item-by-item basis, as § 1.471-4 prefers. It was self-correcting from year-to-year (see Pet.Br. 9). It was subject to annual review by Thor's independent public accountants with a far greater thoroughness than auditors of the Internal Revenue Service can practicably exercise in determining *whether inventory already off the books for financial purposes has in fact been scrapped.*

(Footnote continued from preceding page.)

tion due to handling and exposure to the weather allowed because they were based on a careful evaluation by management); *Justus & Parker Co.,* 13 B.T.A. 127, 130 (1928), *acq.* VII-2 C.B. 21 (1928) (20%, 50% and 100% writedowns by wholesaler of automobile equipment and supplies ". . . by officers . . . familiar with the business and having knowledge of the market value of the material dealt in, is sufficient evidence of the actual market value"); *Lord Motor Car Co.,* 5 B.T.A. 818, 820 (1926), *acq.* VI-2 C.B. 4 (1927) (25% writedown from cost of used car inventory was supported by evidence of actual sales during succeeding year, conformed to statute and Regulations, and clearly reflected income); *The Wickens Co.,* 16 B.T.A. 968, 972 (1929) (10% reduction from cost by furniture retailer approved as "an honest effort to bring the inventory to the basis of cost or market"); *Fred S. Stewart Co.,* 5 B.T.A. 436 (1926), *acq.* VI-2 C.B. 7 (1927) (percentage reductions, applied to several departments of shoe retailer, allowed to establish market value); *Wood & Ewer Co.* v. *Ham,* 14 F.2d 995, 997 (D. Maine 1926) (taxpayer who took percentage reduction of inventory value in several departments of clothing store "made a substantial compliance with the law" in determining fair market value of the inventory).

23. The cases cited by Thor in the preceding footnote upheld percentage writedowns much broader in scope than the supplementary writedown procedure Thor applied to 9 categories of its inventory at two plants where usage records were inadequate. See Pet.Br. 9-10. Thor's supplementary procedure was endorsed by the accounting experts as also conforming to generally accepted accounting principles (Pet.Br. 13).

The reasonableness and accuracy of Thor's formula were confirmed on a seven-year hindsight basis by the testimony of five accounting experts, and of Thor's independent public accountants who had done a special study of the excess inventory procedures when they were first engaged in 1970. Among the numerous facts recited by the experts in reaching their unanimous conclusion was that more than 78% of the 1964 excess inventory had been scrapped by 1971 (see Pet.Br. 10).

Clearly, Thor's excess inventory procedures are not a "reserve for price changes or an estimated depreciation in the value" of inventory within the intended meaning of § 1.471-2 (b)(1), but are objective and reliable procedures designed to determine an existing loss due to excess inventory. If the Commissioner can properly reject Thor's excess inventory procedures as not clearly reflecting income, he effectively has the discretion to reject any such procedures.

(ii) Thor's writedown did not constitute "[t]aking . . . parts of the inventory, at a nominal price or at less than its proper value" as prohibited by § 1.471-2(f)(2). Indeed, the accounting experts established that if Thor had failed to write down the excess stock, its inventory would have been carried at *more*, not less, than its proper value (see Pet. Br. 12-13, 55).[24] Respondent argues (Resp.Br. 44) that "with respect to parts offered and *sold* at unreduced prices, it is plain that petitioner's greatly reduced inventory prices were 'nominal' or 'less than . . . proper value'" (emphasis added). This observation seemingly is off the point because Thor did not write down parts it expected to sell, but only those it anticipated could not be sold. If Respondent is objecting to the fact that Thor's estimate of the unsalable portion of a particular item may

24. In *George Ringler & Co.*, 10 B.T.A. 1134, 1137 (1928), the Board of Tax Appeals permitted the taxpayer to write down beer to salvage value when Prohibition became effective, stating:

> "To require that the goods be returned at cost or on some theoretical market price in excess of its known value would amount to writing into the inventory a value that did not, in fact, exist, and distort the income."

turn out to be too high, the formula automatically adjusts each year to maintain the inventory as closely as possible to correct value (Pet.Br. 9n). The Tax Court has expressly held that the later sale at higher prices of goods written down is not within the scope of § 1.471-2(f)(2). *Ernest, Holdeman & Collet, Inc.*, 19 T.C.M.(CCH) 43, 50, P-H TC Mem.Dec. 60-45, 60-54 (1960), *aff'd on other grounds*, 290 F.2d 3 (7th Cir. 1961), cited with approval in *Space Controls, Inc.* v. *Commissioner*, *supra*, 322 F.2d at 152.

In any event, perfect accuracy in the valuation of inventories is impossible, and Thor should be entitled to the leeway accorded by the "Cohan Rule" formulated by Judge Learned Hand in *Cohan* v. *Commissioner*, 39 F.2d 540, 543-44 (2d Cir. 1930). This rule embodies the realism that "[a]bsolute certainty . . . is usually impossible and is not necessary. . . . It is not fatal that the result will inevitably be speculative; many important decisions must be such." This principle has been applied to a variety of valuation situations, *e.g.*, *Bankers Trust Co.* v. *Higgins*, 136 F.2d 477, 479 (2d Cir. 1943) (certainty not required in predicting income for estate tax valuation purposes); and *Bryant* v. *Commissioner*, 76 F.2d 103 (2d Cir. 1935) (value of real property need not be proved conclusively), including inventory valuation, *e.g.*, *All-Steel Equipment Inc.*, 54 T.C. 1749, 1764 (1970) (allocation of overhead to inventory), *aff'd in part and rev'd on other grounds*, 467 F.2d 1184 (7th Cir. 1972); *Photo-Sonics, Inc.*, 42 T.C. 926, 936 (1964), *aff'd*, 357 F.2d 656 (9th Cir. 1966) (allocation of overhead to inventory), *acq.* 1965-2 C.B. 6; and *Edgar A. Basse*, 10 T.C. 328, 341 (1948) (estimated "increase factor" to cost-of-goods-sold under LIFO method), *acq.* 1950-1 C.B. 1. The Commissioner's understandable desire for exactitude should not allow him to require taxpayers to achieve the impossible, and a reasonable and self-correcting procedure for estimating the value of excess inventory should not be equated with taking inventory "at a nominal price or less than its proper value."

(iii) Respondent also asserts (Resp.Br. 44) that because Thor wrote down items in excess of two years' anticipated supply by 100%, but continued to offer them for sale at unreduced prices, the procedure had the effect of "[o]mitting portions of the stock on hand" prohibited by § 1.471-2(f)(3). This is no more than a variation of the argument that worthless inventory cannot be written down before it is scrapped, and would prohibit the writedown of any worthless inventory, including obsolete inventory, if the taxpayer continues to hold it for sale. Respondent's interpretation would make § 1.471-2(b)(3) inconsistent with the subnormal goods Regulation, § 1.471-2(c), which by its terms does not require a taxpayer to cease trying to sell worthless goods as a condition to writing them down. This interpretation of § 1.471-2(f)(3) also is contrary to the anti-scrapping cases, discussed *infra* at 28, which have uniformly rejected the Commissioner's argument that worthless inventory must be scrapped as a prerequisite to writing it down.

Realistically interpreted, the prohibition against omitting portions of stock on hand can apply only to inventory which has value.

2. *Sections 1.471-4 and 1.471-2(c) Should Be Construed to Be Consistent With the Purposes of § 471 of the Code.* Respondent's analysis (Resp.Br. 45-53) of the market value (§ 1.471-4) and the subnormal goods (§ 1.471-2(c)) Regulations establish—as Thor already conceded in its initial brief (Pet.Br. 64)—that Thor's writedown of excess inventory does not literally conform to the detailed mechanical requirements of these Regulations. But Respondent's selective construction does not at all establish that Thor's writedowns are prohibited by these Regulations—if they are construed to be consistent with the requirement of § 471 that inventory procedures must constitute the best accounting practice.

In construing § 1.471-4(b), Respondent gives no effect to the broad language that ". . . the taxpayer must use such evidence

of a fair market price at the date or dates nearest the inventory *as may be available* . . ." (emphasis added). In fact, in quoting that Regulation, Respondent omits the emphasized phrase (Resp. Br. 51). Instead, Respondent upgrades what are intended to be evidentiary rules for determining fair market price, to absolute prerequisites for a writedown (see, *e.g.*, Resp.Br. 51-53).

In like vein, Respondent's construction of § 1.471-2(c) stresses the rule that to be written down, goods must be offered for sale at a reduced price within 30 days of the inventory date, which the courts have refused to apply when, as here, it is impractical to do so. See Pet.Br. 68 and cases cited therein. Respondent's construction simultaneously wholly overlooks the topic sentence of that Regulation, which authorizes writedowns for "[a]ny goods in an inventory which are unsalable at normal prices . . . ." See discussion at Pet.Br. 67-68.

Section 1.471-2(b) provides that a taxpayer's inventory accounting be "substantially in accord" with the detailed Regulations. In a number of early cases, at which time the development of sound inventory rules was of preeminent concern, courts approved inventory procedures if they constituted reasonable efforts by the taxpayer to fairly value its inventory, even though those procedures did not conform to the precise requirements of the Regulations.

Thus, in *S. G. Sample Co.* v. *Commissioner, supra,* 23 F.2d at 672, the Fifth Circuit refused to require a taxpayer to individually identify the estimated market value of each item in the inventory.[25] To the same effect is *Wood & Ewer Co.* v. *Ham,* 14 F.2d 995 (D. Maine 1926), in which the court noted that Article 1582 of Regulations 45 required—as § 1.471-4(c) continues to require—valuation on an item-by-item basis, but allowed the taxpayer to value portions of inventory by department. The court stated that the purpose of the Regulations was to give the Bureau of Internal Revenue an opportunity to examine the inventory in detail, but not to absolutely require that market

25. See also the cases cited *supra* at 20 n.22.

value be assigned to each item. Accordingly, it held that the taxpayer had "made a substantial compliance with the law and with the regulation." *Id.* at 997.

Wilson Furniture Co., 10 B.T.A. 1294 (1928), has direct applicability to the instant case. There a furniture dealer wrote off out-of-style and damaged "dead stock", but continued to offer it for sale. When any of these items were sold, the entire price was entered into income. Although the Board found that the taxpayer's procedures did not comply with the requirement of the Regulations that "unsalable merchandise should be inventoried at bona fide selling price less cost of selling", the court upheld the taxpayer because "[i]t is clear that the income for the taxable year . . . is substantially accurate. . . ." *Id.* at 1296.

Of particular interest is a decision of the Sixth Circuit, *Rookwood Pottery Co.* v. *Commissioner*, 45 F.2d 43 (6th Cir. 1930), where the taxpayer used ratios of average annual cost to selling price in an effort to reconstruct the cost of returned consignment merchandise, because actual cost data could not be assigned to these goods. The Commissioner disallowed the taxpayer's valuation procedure and substituted a formula of his own. The Sixth Circuit stated, 45 F.2d at 46, that the issue "as between [the] two methods is: which more truly reflects the income?" Recognizing that "income many times cannot be accurately stated . . . [but] can only be, in the language of the statute, 'reflected,' " the court found that the taxpayer's method gave "the truer reflection," concluding, *ibid*:

> "The method presents an intelligible and fairly logical, and probably an approximately correct, result. It was doubtless adopted in good faith by the taxpayer in an effort to get at the best method of representing the truth to its stockholders, and it should not be discarded unless it is essentially wrong—not merely because it may not be exactly right."

This is resonant of the Cohan Rule, *supra* at 23, formulated that same year.

* * *

These cases all interpret the Regulations by practical, common sense standards directed to the ultimate question of whether the taxpayer's inventory procedures meet the statutory requirements of clearly reflecting income and constituting the best accounting practice. In sharp contrast is Respondent's construction of the detailed provisions of the Regulations which would prohibit an inventory procedure which fulfills both statutory standards.

3. *Realization of Inventory Losses is Not Required For Taxpayers Using the Lower-of-Cost-or-Market Basis of Valuation.* Respondent justifies its narrow construction of the Regulations by introducing into inventory accounting the concept that losses must be realized as a condition to any writedown for tax purposes (Resp.Br. 57):

> "Indeed, to permit petitioner's claimed inventory writedown would violate the fundamental principle of our income tax system that a deductible loss must be established by a closed and completed transaction, fixed by identifiable events, and not by fluctuations in value. . . ."

Under this theory, the lower-of-cost-or-market valuation basis, as an exception to the requirement of realization, should be strictly construed to require a taxpayer with excess inventory to either scrap the merchandise or reduce its offering price (Resp. Br. 48, 58).

If realization is required for writedowns of excess inventory, which the law has never heretofore required, the explicit requirement of § 471 that the taxpayer's inventory be valued according to the best accounting practice cannot be fulfilled because the scrapping rule does not conform to generally accepted accounting principles (see discussion *supra* at 3, 10 and Pet.Br. 55-56, 60).

Quite apart from its inherent conflict with the statute, this theory is a radical departure from judicial and administrative precedent governing inventory writedowns. The theory elevates evidentiary requirements of the inventory Regulations to

absolute rules of law, even though the courts generally have rejected that attempt (see discussion *supra* at 25-26). And, most fundamentally, it confuses the concept of "income and loss" with that of "realization".

Respondent cites no case law supporting his thesis; those cited in the Seventh Circuit opinion on this point are inapposite (Pet. A-46—A-47). This very proposition was explicitly rejected by the Fifth Circuit in *Space Controls, Inc.* v. *Commissioner, supra,* 322 F.2d at 148.

Of particular relevance are a number of cases which have criticized and rejected the contention of the Commissioner that worthless inventory must be scrapped to be written off. *C-O-Two Fire Equip. Co.* v. *Commissioner,* 219 F.2d 57, 59 (3rd Cir. 1955), held that an effort to sell obsolete goods did not preclude its writeoff. In *Templeton, Kenly & Co.,* 6 B.T.A. 61, 67 (1927), *acq.* X-1 C.B. 64 (1931), the Board held that scrapping was "merely evidentiary" and had no bearing upon the value of the closing inventory. *Ernest, Holdeman & Collet, Inc.,* 19 T.C.M. (CCH) 42, 51, P-H TC Mem.Dec. 60-43, 60-54 (1960), cited with approval in *Space Controls, Inc.* v. *Commissioner, supra,* 322 F.2d at 152, equated realization with the writeoff rather than physical scrapping:

> ". . . [P]etitioner valued its inventory at lower of cost or market. . . . When it became apparent that the going market value of a particular machine was less than petitioner's cost basis, the inventory valuation was reduced to accord with market. . . . This procedure properly resulted in the realization of a loss when it occurred—the year the machine became worthless, not necessarily the year the machine was physically cast upon the scrap pile."

See also *McKay Machine Co.,* 28 T.C. 185, 194 (1957).

Respondent's theory also is inconsistent with numerous provisions of the inventory Regulations governing other inventory methods which permit the writedown of unrealized losses, *e.g.,* § 1.471-6(d) (farm-price method); § 1.471-6(e) (unit-livestock-price method); and § 1.471-8(a) (retail inventory method).

One of the landmark early rulings on inventory concepts by the Treasury Advisory Tax Board, T.B.R. 48, 1 C.B. 47, 49-50 (1919), made it clear that realization is not required for taxpayers using the lower-of-cost-or-market valuation basis because that would be unsound in principle:

> ". . . A loss may be occasioned by physical destruction or deterioration of property included in an inventory or it may be attributable to changes in styles or other causes affecting salability, or it may be occasioned by shrinkage in market value. Where such losses arise, even though not fully consummated by a sale of the goods, the fact should nevertheless be recognized, and when such goods are taken in an inventory they may, if the taxpayer so elects as a consistent policy, be valued at market instead of cost, where market is lower. This is true even in spite of the possibility that conditions may change, and at a date before a sale is made the goods may again be worth their original cost. . . . In a very real sense losses may be admitted, while profits must be proved. Capital once impaired is gone, but the admission of a loss not fully realized by a completed transaction results in nothing more serious than a postponement of profit to a subsequent period. . . . The rule of cost or market, whichever is lower, even though it may appear to lack in consistency, thus, nevertheless, rests upon solid ground, and its widespread adoption throughout the business world amply justified its adoption for tax purposes."

Interpretations shortly after enactment of a law, as Mr. Justice Cardozo observed, have ". . . peculiar weight when it involves a contemporaneous construction of a statute by the men charged with the responsibility of setting its machinery in motion, of making the parts work efficiently and smoothly while they are yet untried and new." *Norwegian Nitrogen Prod. Co.* v. *United States,* 288 U.S. 294, 315 (1933).

Respondent's theory in effect incorporates realization into the definition of income. This is untrue generally for tax accounting —for example the accrual of income and expense, and the doctrine of constructive receipt—and it has never been true for inventory accounting. The distinction has never been better

illuminated than in Henry J. Simons, Personal Income Taxation 84 (1938):

> "One realizes on assets; one converts assets from one form into another; and one may 'realize' cash, potatoes, or chicken pox. But gain simply is not something which may be delivered at one's doorstep. One may gain without realizing and realize without gaining; and if either is essential to the existence of income, the other must be excluded. Common sense and established usage suggest that gain is the true *sine qua non;* but much of the current discussion of the income concept, especially by the courts, may be regarded as emphasizing realization to the exclusion of gain."

Section 471 requires that inventories clearly reflect "income", not "realized income". Inasmuch as Congress has been aware for almost 60 years that inventory losses could be recognized without realization, one must assume that it intended, in the many reenactments of § 471, the statute to mean what it says.

Respondent's effort to require realization for excess inventory losses seemingly is founded on the fear that anything less "objective" will engender tax avoidance through taxpayer manipulation of inventory values from year to year (Resp.Br. 58). In truth, a writeoff system such as Thor's, objectively based on actual sales, computed on an item-by-item basis, self-correcting, and subject to annual review by independent auditors, is largely immune to taxpayer manipulation. The scrapping rule is not, because the inventory already will have been written off for financial accounting purposes, so the taxpayer will be free (subject to his business needs for spare parts) to choose the years in which scrapping losses will yield the greatest tax benefit. This freedom will be particularly beneficial to taxpayers subject to progressive tax rates—*e.g.*, all businesses conducted as proprietorships, partnerships and subchapter S corporations, as well as all corporations whose annual income regularly or occasionally is less than $100,000,[26] comprising

26. Corporate tax rates are progressive under current law to $50,000 and will be steeply progressive to $100,000 under the recently enacted Revenue Act of 1978.

over 99.5% of all businesses[27]—who will scrap in high income years.

D. The Non-Inventory Accounting Cases Are Not Authority for Determining Whether or Not Thor's Inventory Procedures Were Proper Under § 471

Respondent concludes its principal argument by accurately observing that this Court has held that generally accepted commercial accounting principles do not necessarily govern computation of taxable income, particularly as to reserves for future expenses and the deferral of income, which are customarily permitted, and even required, under generally accepted accounting principles (Resp.Br. 58-65). Respondent goes on to inaccurately characterize Thor's excess inventory writedown as "estimates of an anticipated loss [which] is nothing more than a reserve to cover a contingency that may arise in the future" (Resp.Br. 62). As has been shown, *supra* at 6-7, that factual characterization is contrary to the finding of the Tax Court, based on the unanimous testimony of the expert accounting witnesses, that the writedown recognized a currently existing loss, not a future one.

As Thor's initial brief demonstrated (Pet.Br. 45-48), the prepaid income and the expense reserve cases are not applicable to inventory accounting, and, until the decisions below, have never been so viewed. This derives not only from conceptual differences already discussed, *supra* at 28-30, but also from statutory and constitutional distinctions established during the earliest days of the income tax.

Since the Revenue Act of 1918, inventories have been governed by § 471 and its predecessors, which require not only that they clearly reflect income but that they constitute a best accounting practice. Except for the general rule of § 446, there is no equivalent provision for other prepaid income and reserves for future expenses, the absence of which is dramatized by the

27. Internal Revenue Service, Statistics of Income—1973, Corporation Income Tax Returns 128 (1977).

short-lived existence of §§ 452 and 462 which provided for them (see Pet.Br. 46, 47n).[28]

The special dependence of § 471 upon financial accounting standards, expressed in the term "best accounting practice", may in part be due to the fact that cost-of-goods-sold—which depends on opening and closing inventory values—must be taken into account in calculating gross income under the Sixteenth Amendment. See Tax Court's opinion (Pet. A-17). In *Lela Sullenger*, 11 T.C. 1076, 1077 (1948), *appeal dismissed* (5th Cir. 1950), *nonacq.* 1949-1 C.B. 6, *acq.* 1952-2 C.B. 3, *nonacq.* 1976-1 C.B. 1, the Tax Court stated:

> "Section 23 [now § 61] makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts in order to arrive at gross income. No more than gross income can be subjected to income tax upon any theory."

Thus, in contrast to all other deductions which are discretionary with the legislature, *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934), a taxpayer is entitled to have his cost-of-goods-sold determined through a correct valuation of his opening and closing inventory.

E. Section 446(e), Which Requires the Prior Consent of the Commissioner for a Taxpayer to Change Its Method of Accounting, Is Not Applicable to Thor's Writedown of Excess Inventory

Respondent contends, as an alternative ground for affirmance, that Thor changed its method of accounting in 1964 without

28. It should be recalled that these sections were repealed not as a matter of tax accounting principle, but because of the large and unexpected revenue loss during the transition period when taxable income was being deferred pursuant to § 452 and expense accrual accelerated under § 462. See H.R. Rep. No. 293, 84th Cong., 1st Sess. 3-4 (1955); S. Rep. No. 372, 84th Cong., 1st Sess. 3-5 (1955).

obtaining the prior consent of the Commissioner required by § 446(e), which provides:

> ". . . a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate."

Because the statutory notice of deficiency (A3) did not assert that Thor had changed its method of accounting, the Tax Court properly ruled, prior to trial, pursuant to Rule 32 of the Tax Court (now Rule 142), and reiterated at the outset of trial (A30-A32), that the burden of proof on this issue affirmatively was on the Commissioner.[29] Inasmuch as the Tax Court reached no decision on this complex issue, at most it should be grounds for remand. See *Aetna Casualty & Surety Co.* v. *Flowers*, 330 U.S. 464, 468 (1947); *United States* v. *Ballard*, 322 U.S. 78, 88 (1944).

In any event, this is a phantom issue. Even if it were assumed that Thor changed its excess inventory valuation procedures at the end of 1964, which the Commissioner did not prove, and if it were further assumed that the supposed change constituted a change in Thor's "method of accounting," which it did not, the change in Thor's procedures cannot cause any income of Thor to be omitted or cause any double increase in its cost-of-goods-sold. Both § 446(e), upon which Respondent relies, and its companion enactment § 481, establish that the statutory purpose is to "prevent amounts [of taxable income] from being duplicated or omitted." See discussion *infra* at 42-44.

If Thor did change its method of accounting, it would be required to resume its pre-1964 procedure for valuing excess inventory.[30] The only possible differences between the "old"

29. Respondent acknowledges this burden of proof at p. 10 n.11 of his brief, but does not mention it in his argument at pp. 65-71.

30. To illustrate, the issue whether Thor changed its method of accounting is of independent significance only if this Court holds that Thor's 1964 inventory procedures clearly reflect income, since a contrary holding would be sufficient to sustain the lower court's

(Footnote continued on next page)

procedures and those used by Thor in 1964 is ***how much*** excess inventory would be written off in 1964 and how much in each year thereafter. The *total* amount written off will not be affected by which procedure is used. Thus, there is no potentiality for the omission of income or of a double deduction (*i.e.*, a double increase in Thor's cost-of-goods-sold), which means that any change in Thor's excess inventory procedures simply is outside the scope of § 446(e).

1. *The 1970 Amendments to Regulations § 1.446-1(e) Are Not Properly Applicable to Thor's 1964 Tax Year.* The question whether Thor changed its method of accounting in 1964 is subject to the preliminary issue of whether a 1970 amendment to the Regulation can affect the 1964 tax year. Respondent relies upon Regulation § 1.446-1(e), as amended by T.D. 7073 (filed November 17, 1970), 1970-2 C.B. 98, which substantially expanded the definition of what constitutes a change in a "method of accounting" by enlarging the subordinate concept of what is a change in the treatment of a material item.[31] See detailed discussion *infra* at 41. Apparently Respondent believes the amendment to be retroactively effective for all taxable years

(Footnote continued from preceding page.)

decision. If this Court does hold that Thor's 1964 inventory procedures clearly reflect income, and if on remand the Tax Court determines that Thor changed its method of accounting, then the only option open to that court is to require Thor to resume its pre-1964 procedure for valuing excess inventory. Thor could not be required to keep worthless inventory on the books at full cost, since that would conflict with the holding of this Court that Thor's inventory write-down procedures clearly reflected income. Under § 446(b), the Commissioner cannot substitute a method of accounting for one which clearly reflects income. *Thompson-King-Tate, Inc.* v. *United States*, 296 F.2d 290, 294-95 (6th Cir. 1961).

31. Before 1970, Regulation § 1.446-1(e)(2)(ii) illustrated a change requiring the Commissioner's consent to be "a change involving the *method or basis* used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder) . . ." (emphasis added).

After the amendment, § 1.446-1(e)(2)(ii)(c) defined a change requiring consent to include:

(Footnote continued on next page)

commencing on or after January 1, 1954.[32] No doubt Respondent relies on § 7805(b), which embodies the extraordinary concept—not generally applicable to regulations of other agencies—that all Treasury Regulations and their amendments are retroactive unless otherwise specified by the Secretary. Notwithstanding that rule, this Court has not permitted amendments to Regulations to have retroactive effect where the amendment was not remedying a mistake of law and where the taxpayer could not reasonably have anticipated the change. *Central Illinois Public Service Co.* v. *United States*, 435 U.S. 21, 32 (1978); *Helvering* v. *Griffiths*, 318 U.S. 371, 402-403 (1943);[33] *cf. Helvering* v. *R. J. Reynolds Tobacco Co.*, 306 U.S. 110, 115-117 (1939). Indeed, the courts below followed *Reynolds Tobacco* to hold in this very case that the 1973 amendment to § 1.471-2(b) was not retroactively effective to 1964 (Pet. A-22, A-39 n.11). See Thor's initial brief (Pet.Br. 32n).

(Footnote continued from preceding page.)

> "A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material items used in the overall plan for identifying or valuing items in inventory is a change in method of accounting."

32. This is not asserted in the argument portion of Respondent's brief, which cites and quotes from the amended Regulation without identifying the 1970 amendments. In the Appendix to its brief (p. 84), Respondent states that the amendment is retroactive.

33. "We are asked to make a retroactive holding that for some seven years past a multitude of transactions have been taxable although there was no source of law from which the most cautious taxpayer could have learned of the liability. If he consulted the decisions of this Court, he learned that no such tax could be imposed; if he read the Delphic language of the Act in connection with existing decisions, it, too, assured him there was no intent to tax; if he followed the Congressional proceedings and debates, his understanding of nontaxability would be confirmed; if he asked the tax collector himself, he was bound by the Regulations of the Treasury to advise that no such liability existed. It would be a pity if taxpayers could not rely on this concurrent assurance from all three branches of the Government. But we are asked to brush all this aside and simply to decree that these transactions are taxable anyway." 318 U.S. at 402.

There are persuasive reasons for denying retroactivity to the 1970 amendment of § 1.446-1(e). When Thor was valuing its inventory near the end of 1964, even if it had suspected that it might be making a change in its method of accounting for tax purposes, it would have found nothing in then-existing § 1.446-1(e) even hinting that its year-end valuation procedures might constitute a change of its inventory *method* (FIFO and standard costs) or of its *basis* of inventory valuation (lower-of-cost-or-market), requiring the consent of the Commissioner. See § 1.446-1(e)(2)(ii) quoted *supra* at 34 n.31. Case research would have unearthed not a single decision suggesting the possibility. Research might have discovered a well-publicized 1961 letter from the Commissioner to the Committee on Federal Taxation of the A.I.C.P.A. stating that the tentative view of the Internal Revenue Service was that "the classification of stock as unsalable at normal prices without regard to the requirements of section 1.471-2(c) of the Regulations" was not a change of "method" requiring consent (but was an "error" that did not require consent). This letter is excerpted in Patton, *Inventory Procedures: Recent Developments in Internal Revenue Service's Attitude,* 23 N.Y.U. Institute on Federal Taxation 839, 844-45 (1965). These facts are reminiscent of those recited in *Griffiths,* quoted *supra* at 35 n.33.

Notwithstanding what was known or knowable by Thor in 1964, Respondent now seemingly assumes that Thor should have anticipated the 1970 amendments and filed a request with the Commissioner in 1964 to change its method of accounting. One can imagine Thor's request reading "In the event that future amendments to the Regulations ever retroactively make the proposed inventory procedures a change in accounting method, permission is hereby contingently requested for such a change." How would the Commissioner respond to such a request? To paraphrase the opinion of this Court in *Central Illinois Public Service Co., supra,* 435 U.S. at 32: no taxpayer, in viewing the Regulations in 1964, could reasonably suspect that a consent

obligation existed. See also 435 U.S. at 38 (Powell, J. concurring).

2. *If Thor Instituted Any Change in Its Procedure for Valuing Excess Inventory in 1964, It Did Not Constitute a Change in a Method of Accounting Within the Meaning of § 446(e).* There are three prerequisites to the application of § 446(e):

(i) the change by the taxpayer must be of a "method of accounting",

(ii) that causes income to be omitted or the same expense to be deducted twice, and

(iii) which is not merely a correction of mathematical or posting errors, an erroneous application of the taxpayer's accounting method, or a response to a change in the underlying facts.

The alleged changes by Thor of its inventory valuation procedures in 1964 do not meet any of these three requirements, as shown in (i), (ii), and (iii) below.

(i) Section 446(e) provides:

> ". . . a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary or his delegate."

The statute does not refer to a "change in the treatment of a material item". This concept derives from the Committee Reports accompanying § 446(e):[34]

> "Subsection (e) codifies existing regulations. A change in the method of accounting includes a change in the

34. Section 446(e) was a codification of Regulations 118, § 39.41-2(c) which trace back to Regulations 45, Article 23, as amended by T.D. 2873, 1 C.B. 58 (1919). Prior to the 1954 Code, the Regulations did not refer to a "change in the treatment of a material item" because until then hybrid methods of accounting were prohibited, *e.g., Massachusetts Mutual Life Insurance Co.* v. *United States,* 288 U.S. 269, 273-74 (1933); *United States* v. *Anderson,* 269 U.S. 422, 440 (1926).

general method of accounting such as a change from the cash receipts and disbursements method to an accrual method, or vice versa, or a change from the cash or an accrual method to the long-term contract method, or vice versa. It also includes a change in the treatment of a *material item* such as a change in the *method* of valuing inventory, or a change from an accrual method without estimating expenses to an accrual method with estimated expenses, or vice versa, or a change in the method of depreciating any property. *A change in the method of accounting is a substantial change as distinguished for* [sic] *each change in the treatment of each item.*" (Emphasis added.) H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 300 (1954).

This excerpt discloses that Congress intended § 446(e) to apply only to substantial accounting changes adopted by a taxpayer. There is no suggestion of a Congressional intention to inhibit the flexibility of taxpayers to improve their accounting procedures or to alter them to meet new or changing conditions. This policy has a practical administrative benefit to the Commissioner by limiting requests for accounting changes to major matters.

One type of substantial change is, in the words of the Reports quoted above "a change in the method of valuing inventory". This language was expanded moderately by the initial Regulation § 1.446-1(e), promulgated in 1957 by T.D. 6282 (filed December 25, 1957), 1958-1 C.B. 215, which listed as an example of a change requiring the Commissioner's consent ". . . a change involving the *method or basis* used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder). . ." (emphasis added).[35] The terms "method" and "basis" had at that time, as now, a definite and established meaning.

35. Regulation § 1.446-1(e)(2) then defined and illustrated the changes requiring consent as follows:

(Footnote continued on next page)

Section 1.471-2(c) of the Regulations defines "basis of valuation" as "cost" and "cost or market, whichever is lower". "Method" is a more generic term and includes the LIFO method (I.R.C. § 472 and § 1.472-1(a) of the Regulations thereunder), farm-price method (§ 1.471-6(d)), unit-livestock-price method (§ 1.471-6(e)), and retail price method (§ 1.471-8), as well as cost accounting systems such as the full absorption method (§ 1.471-11(a)), the manufacturing burden rate method (§ 1.471-11(d)(2)), and the standard cost method (§ 1.471-11(d)(3)). Thus, the Committee Reports and the initial Regulation interpreting them limited the definition of a change in the "treatment of a material item" in inventory accounting to a change in an inventory "method" or a change in the "basis" for valuing inventory. There is no evidence of any intention to require the Commissioner's consent for a change in the subordinate procedural details of an inventory method or valuation basis. This limited definition is wholly consistent with the explicit statement in the Committee Reports that § 446(e) is intended to encompass only "a substantial change as distinguished for [sic] each change in the treatment of each item." See passage quoted *supra* at 37-38.

(Footnote continued from preceding page.)

"(i) . . . A change in the method of accounting includes a change in the overall method of accounting for gross income or deductions, or a change in the treatment of a material item. . . ."

"(ii) Examples of changes requiring consent are: A change from the cash receipts and disbursements method to an accrual method, or vice versa; a *change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder)*; a change from the cash or accrual method to a long-term contract method, or vice versa (see § 1.451-3); a change involving the adoption, use, or discontinuance of any other specialized method of computing taxable income, such as the crop method; or a change in the treatment of any other items of income or expense, where material." (Emphasis added.)

The foregoing was not changed by amendments to this Regulation effected by T.D. 6584 (filed December 21, 1961), 1962-1 C.B. 67.

There appears to be only one reported case in which the Commissioner has argued that a change of a material item that is a component of an established inventory method constituted a change in a method of accounting. His assertion was rejected by the Tenth Circuit in *Monfort of Colorado, Inc.* v. *United States*, 561 F.2d 190 (10th Cir. 1977), *aff'g* 406 F.Supp. 701 (D.Colo. 1976), which held that a change by the taxpayer *from* treating hedging gains and losses as income *to* adjusting ending inventory by such gains and losses did not constitute a change in the taxpayer's method of accounting. The Tenth Circuit quoted with approval the District Court's conclusion that ". . . it seems clear that the kind of change in accounting method requiring the Commissioner's prior consent is a change in the basic method of reporting and not in the treatment of specific items." *Id.* at 197.[36]

Thor did not change either the "method or basis" for valuing its inventories in 1964. It continued, as it had in previous years, to use the FIFO with standard cost method, and the lower-of-cost-or-market basis for valuing its inventories. Subordinate to its method and basis of valuation, Thor continued, as it always had, to write off inventory when Thor's management concluded that it was worthless.[37]

36. None of the cases cited by Respondent involved a change in either inventory method or procedures: *Commissioner* v. *O. Liquidating Corp.*, 292 F.2d 225 (3rd Cir. 1961) (change from accrual to cash receipts method for reporting dividends received from a mutual insurance company); *American Can Co.* v. *Commissioner*, 317 F.2d 604 (2d Cir. 1963) (change from cash receipts to accrual method for deducting taxes and vacation pay); *Wright Contracting Co.* v. *Commissioner*, 316 F. 2d 249 (5th Cir. 1963) (partial change from accrual to completed contract method); *Peoples Bank & Trust Co.* v. *Commissioner*, 415 F.2d 1341 (7th Cir. 1969) (improper accrual of interest expense which the Commissioner required to be discontinued).

37. The distinction between an inventory method and an underlying procedural component of it is well-illustrated by Rev. Rul. 75-445, 1975-2 C. B. 74, involving the valuation of accounts receivable. The Ruling held that a bank which used the reserve method for calculating its bad debts under § 166(c) could change its procedures

(Footnote continued on next page)

Respondent in effect argues (Resp.Br. 67-68) that the concept of material item in inventory accounting is governed by the 1970 amendments to the Regulation, notwithstanding that they were issued six years after the tax year in question. See discussion *supra* at 34-37. Section 1.446-1(e)(2)(ii)(c), as amended, provides:

> "A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting."

The second sentence is not based on any statutory language, but conflicts with the plain legislative intention (discussed *supra* at 37-38). It is not derived from any judicial authority. This is a classic example of what this Court described in *Central Illinois Public Service Co., supra*, 435 U.S. at 31 (1978), as a "narrow and precise" standard established by Congress which "administrative and other pressures seek to soften and stretch."[38]

(Footnote continued from preceding page.)

for calculating the reserve from the "percentage method" to the "experience method" without consent of the Commissioner because neither valuation procedure was a method of accounting within the meaning of § 1.446-1(c). The "reserve method" itself was held to be the method of accounting. By analogy, Thor's inventory method is FIFO and standard costs with the lower-of-cost-or-market valuation basis, and its excess inventory procedures are equivalent to the underlying percentage and experience methods for calculating the bad debt reserve.

38. Examples 7 and 8 of the 1970 version of § 1.446-1(e)(2)(iii), cited at Resp.Br. 68 n.31, are distinguishable by the fact that they illustrate changes of a valuation "basis" and the base stock "method" respectively.

Of more relevance is Example 9 of the proposed amendments to the Regulation, see Notice of Proposed Rulemaking, 33 Fed. Reg. 18936, 18937 (1968), which is given as an example of a change in an inventory method:

> "A taxpayer values inventories on the basis of cost or market, whichever is lower. This value has been consistently and systematically written down for estimated obsolescence. Although such

(Footnote continued on next page)

(ii) The general comments on the accounting provisions of the 1954 Code in both the House and Senate Committee Reports could not be more explicit as to the purpose of § 446(e):

> "The changes embodied in your committee's bill are designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles, and to assure that *all items of income and deductions are taken into account once, but only once, in the computation of taxable income.*" (Emphasis added.) H.R. Rep. No. 1337, 83rd Cong., 2d Sess. 48 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 62 (1954)[39]

The Treasury Regulations have been faithful to this purpose. In 1964, § 1.446-1(e)(3) provided:

> "The taxpayer shall, to the extent applicable, furnish all information . . . disclosing in detail all classes of items which would be treated differently under the new method of accounting and showing all amounts which would be *duplicated or omitted* as a result of the proposed change." (Emphasis added.)

This interpretation of the Congressional intent is reinforced by the language of § 481, which first appeared in the 1954 Code as a companion to § 446(e). Section 481 is designed to protect against income being omitted or deductions duplicated if either a taxpayer made an unauthorized change in his method of accounting, or the Commissioner required a taxpayer, pursuant to § 446(b), to change an incorrect method of accounting which did not clearly reflect income. When the Commissioner compelled such a change, pre-1954 case law usually would permit

(Footnote continued from preceding page.)

writedowns are improper treatments of a material item used within the framework of the overall plan, a change to eliminate the use of this practice is a change of method of accounting for inventories."

The unexplained deletion of this Example from the final amendments to the Regulation implies that the Treasury drafters concluded that it did not illustrate a change in a method of accounting.

39. The emphasized language is also directed to § 481.

the omission of income or a double deduction caused thereby. To correct this and create symmetry between voluntary taxpayer and Commissioner induced changes, § 481(a)(2) provides that:

> "There shall be taken into account those adjustments which are determined to be necessary solely by reason of the change [in a method of accounting] in order to prevent amounts [of income and expense] from being duplicated or omitted. . . ."

The discussion of § 481 in both the House and Senate Committee Reports stated:

> "Adjustments Required By Changes In Method Of Accounting. If there is a change in the method of accounting employed in computing taxable income from the method employed for the preceding taxable year, adjustments must be made in order that every item of gross income or deduction is taken into account and that none are omitted. At the same time no item is to affect the computation of taxable income more than once. It is only those omissions or doubling ups which are due to the change in method which must be adjusted." See H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A164 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 307 (1954).

The Congressional purpose is clearly embodied in the Regulations interpreting § 481, *e.g.*, § 1.481-1(a)(1), (b), and § 1.481-2(d), *Example (1)*.

The commonality of purpose between § 446(e) and § 481 is demonstrated by the fact that they are both triggered by a change in a "method of accounting". The use of this term in § 446(e) shows that the purpose of that section is to enable the Commissioner to review proposed changes to determine whether they will result in an omission of income or a doubling of deductions.[40]

40. Thor can find no case which discusses this clear statutory requirement of §§ 446(e) and 481. See *Hackensack Water Co.* v. *United States*, 352 F.2d 807, 810 (Ct. Cl. 1965), discussing this requirement under pre-1954 regulations.

Respondent does not allege that any changes in Thor's procedures resulted, or even had the potentiality to result, in income escaping taxation or in a double deduction (*i.e.*, double increase in cost-of-goods-sold). Depending on one's viewpoint, Thor's 1964 valuation procedures resulted in a belated writeoff in 1964 of valueless inventory, some of which should have been written off in earlier years (as Respondent alternatively asserts); constituted a correct writeoff in 1964 (as Thor argues); or accelerated a writeoff belonging in future years (as Respondent primarily contends). A change between any of these alternatives, however, can result in any income escaping tax or in a double increase in cost-of-goods-sold, and therefore even if there were a change in Thor's excess inventory valuation procedures in 1964, it was outside the scope of § 446(e).

(iii) Excluded from the definition of a change of a method of accounting are the correction of mathematical or posting errors, an erroneous application of the taxpayer's accounting method, and a response to a change in underlying facts.[41] See *W. A. Holt Co.* v. *United States*, 368 F.2d 311 (5th Cir. 1966) (writeoff of accounts receivable which were not worthless was an improper deduction rather than a method of accounting); *Korn Industries, Inc.* v. *United States*, 532 F.2d 1352, 1355-56 (Ct. Cl. 1976), *nonacq.* Rev. Rul. 77-134, 1977-1 C.B. 132 (error in allocating three items of overhead not a method of accounting); and *Walter H. Potter*, 44 T.C. 159, 170-71 (1965) (improper application of cash receipts method by excluding portion of face amounts of notes received on the sale of houses not a method of accounting).

If Thor introduced new procedures for identifying and writing off excess inventory in 1964, they were a reaction to a change of circumstances, a better application of an existing method, a correction of an error in judgment made in earlier years, or

41. The first and third of these exceptions are recognized by the current Regulations. See § 1.446-1(e)(2)(ii)(b) and (c), and § 1.446-1(e)(2)(iii), *Example (4)*. The Regulations in effect in 1964 did not refer to any of these exceptions.

a mixture of all of these, rather than a change in Thor's inventory method, which continued to be FIFO with standard costs, or in its lower-of-cost-or-market valuation basis.[42]

* * *

In summary, even if Thor changed its procedures for valuing excess inventory at the end of 1964 (which the Commissioner did not establish), such procedural changes, as a matter of law, would not constitute a change in Thor's method of accounting for any one of these reasons: (i) it was not a change in Thor's inventory valuation basis or method, which respectively continued to be the lower-of-cost-or-market and FIFO with standard costs; (ii) it could not result in the omission of income or a double increase of Thor's cost-of-goods-sold; and (iii) it was at most in the nature of a correction of a previous erroneous application of Thor's accounting method or a reaction to a change in underlying facts.

3. *The Evidence Is Insufficient to Meet the Commissioner's Burden of Proof That § 446(e) Is Applicable.* In order to meet his burden of proof, the Commissioner was required to establish (i) that Thor changed its procedures for valuing excess inventory at the end of 1964; (ii) that such change resulted in the omission of income or a double increase of cost-of-goods-sold; *and* (iii) that such change constituted a "method of accounting", rather than the correction of an erroneous application of Thor's established accounting method or a reaction to changed circumstances. If the statement in Thor's tax return for 1964 is con-

42. To the extent that Thor's excess inventory writedown in 1964 fell within any of these categories, both judicial authority and the Commissioner's usual practice establish that the proper year for writeoff is 1964, when Thor determined, *as a reasonable exercise of business judgment*, that there was excess inventory (see Pet.Br. 70-71).

Alternatively, if the 1964 writedown is deemed to require an adjustment of the results of earlier years, all of the necessary adjustments in Thor's taxable income for those years can be made. The years 1961 through 1963 in effect are open pursuant to § 6214(b), and liability for years before that can be recalculated under §§ 1311 *et seq.* (see Pet.Br. 70n).

strued most favorably to the Commissioner,[43] the first of these elements may have been partially proved. The others were not. The Commissioner did not establish such threshold facts as what procedures Thor used in prior years for valuing excess inventory, what the results of those procedures were, or whether Thor in fact had excess inventory prior to 1964 that was not written off pursuant to a correct application of Thor's then valuation procedure.

To be specific, the record demonstrates that Thor adjusted closing inventory in each of the years 1960 through 1963 to write down parts for discontinued tools on a 10-year amortization basis (Stip. ¶ 6(a), A24). Otherwise the record is silent as to whether Thor employed any other procedures in 1963 and earlier years to identify the existence of excess inventory. There is no evidence whether there were any inventory writedowns, which could have been posted either directly to inventory accounts or to the reserve fór inventory valuation (RIV)—or contrawise whether management reasonably determined, after analysis, that there was no excess inventory in addition to that adequately provided for by the 10-year amortization writedown.

Respondent called no witnesses to establish the necessary facts. It did not cross-examine Thor's president or other witnesses on these facts. Instead, it introduced nine exhibits, consisting principally of Thor's reports to shareholders and to the S.E.C. for 1963 to 1965, presumably on the theory that these documents contained admissions by Thor that it had changed its procedure for valuing excess inventory in 1964. These documents, excerpted in relevant part at pp. 227-263 of the Appendix, do not support Respondent's contention, much less sustain his burden of proof.

43. Thor declared on its 1964 return that its inventories:

". . . were priced at the lower of cost <first-in, first-out> or market, such inventories are stated on the same basis and were determined generally in the same manner as inventories at December 31, 1963 except that as a result of revision in operating policies made late in 1964, revised procedures were adopted to value excess stock." (Ex. 7-G, A38, A226.)

In evaluating these documents, it is necessary to be mindful that they employ terms of financial accounting, not of tax accounting. Financial accounting uses the phrase "change in generally accepted accounting principles" to mean a major change such as from accrual to cash basis or from the LIFO to the FIFO inventory method. The equivalent in tax accounting terminology is a "change in a method of accounting". In financial accounting, any change less than one of "principle" is variously designated as a change of "method," "procedure," "practice," or "technique". The equivalent terminology in tax accounting is a change in "practice" or "procedure". Thus, a change of "method" in financial accounting is a minor change not equivalent to a major change of "method" in tax accounting. See testimony of the expert accounting witnesses (A115-A119, A142-A143, A163-A166, A182-A183).

Although several of Thor's reports to its shareholders and to the S.E.C. for 1964 and 1965 stated that Thor had changed its "procedures" or "methods" for valuing obsolete and excess inventory at the end of 1964 (*e.g.*, Ex. P, A47, A227, A232; Ex. Q, A47, A235; Ex. R, A47, A245, A247-A248, all quoted at Resp.Br. 5-6, 8, 69-70), nowhere did those reports indicate that Thor had made a change of accounting *principle* as to the valuation of its inventory. This is clearly shown in Thor's amended Form 10-K to the S.E.C. for 1964 (Ex. S, A47, A249-A261). That document lists three categories of adjustments by Thor at the end of 1964 (A250-A251). Only the second category, which did not include any inventory adjustment, involved changes in the application of generally accepted accounting principles (A258-A259).

Thor confirmed this documentary evidence by questions to the expert accounting witnesses. Four of them were asked the hypothetical question: if it were assumed that Thor had used only the 10-year amortization procedure prior to 1964, and first adopted the primary and supplementary procedures in 1964, would such a change constitute a change in accounting

principle. The unanimous answer was no (A117, A143, A165-A166, A183). This, as explained above, is equivalent to stating in tax accounting terminology that Thor did not make a change in its method of accounting.

Except for the 10-year amortization writeoffs, there is no evidence in the record as to what procedure Thor used to identify and value excess inventory in 1963 and earlier years, whether it wrote off any such excess in those years, or whether it determined in those years that there was no excess.[44] But even more decisive, the Commissioner did not show that any change by Thor of its inventory valuation procedures could result in an omission of income or a double increase of its cost-of-goods-sold. The Commissioner simply did not meet his burden of proof.

* * *

For all these reasons, the allegation that Thor changed its method of accounting does not justify either an affirmance or a remand.

II.

BAD DEBT ISSUE

Respondent succeeded in briefing (Resp.Br. 71-75) the bad debt issue without once referring to Treasury Regulation § 1.166-4(b)(1) which declares that:

> "What constitutes a reasonable addition to a reserve for bad debts shall be determined in light of the facts existing at the close of the taxable year of the proposed addition."

This is in stark contrast to Respondent's treatment of the inventory issue where he principally relied on "the detailed pro-

44. This lack of evidence is not remedied by quoting out of context, as does Respondent, the puzzling observation of the Seventh Circuit (Pet.A-45) that ". . . the new management adopted a valuation method which resulted in overall write-downs of nearly $4 million in 1964, as compared with a small fraction of that amount in the preceding years" (Resp. Br. 69). The total inventory write-down of $4,000,000 due to a variety of causes (see A52-A53) has no relevance in establishing that the $927,000 writedown for excess inventory in 1964 constituted a change in Thor's accounting method.

visions of the Regulations upon which this case must ultimately turn" (Resp.Br. 38).

Although the Regulation requires examining the "facts existing at the close of the taxable year of the proposed addition," Respondent seeks to look instead both backward and forward from that date to determine the reasonableness of Thor's bad debt reserve. Respondent defends the validity of the *Black Motor* formula which looks only backward. He simultaneously stresses that Thor did not introduce evidence of eventual non-collections to prove the accuracy of its 1965 addition to its reserve for bad debts (Resp.Br. 73-74).[45]

Although Respondent expressed grave concern about the supposed ability of the taxpayer to manipulate excess inventory writeoffs, if they are not based on the scrapping rule, he does not address Thor's argument that the *Black Motor* formula is susceptible to taxpayer manipulation because it directly depends on actual bad debt writeoffs by the taxpayer (Pet.Br. 75). Moreover, no explanation is offered by Respondent why the reserve method under § 166(c) should, through use of the *Black Motor* formula as a *per se* standard, directly depend on the taxpayer actually charging debts off its books, when Congress has eliminated that requirement as a condition to deducting bad debts pursuant to the general provisions of § 166(a) (see Pet.Br. 76).

Respondent likewise bypasses any discussion of the original limited purpose of the *Black Motor* formula or of the fact that that formula is inherently arbitrary (Pet.Br. 75); coordinately, Respondent ignores the finding of the Tax Court as to the detailed account-by-account review undertaken by Thor's personnel most familiar with Thor's debtors and the sequential re-

45. These arguments are squarely inconsistent with the positions Respondent has taken on the inventory issue. Respondent vigorously objects to Thor's excess inventory writedowns even though they were based on Thor's sales and production usage experience. Thor's extensive hindsight evidence demonstrating the accuracy of its 1964 excess inventory writedown is treated by Respondent as irrelevant; in fact, that evidence was admitted over the strenuous objections of trial counsel for the Commissioner (A87, A90-A91).

view by three levels of Thor's management (Pet. A-16), *the accuracy of which has not been questioned by the Commissioner or by the courts below.*

Instead of facing any of these fundamental issues, Respondent cites cases in which courts have approved use of the *Black Motor* formula, *Atlantic Discount Co.* v. *United States,* 473 F.2d 412, 414-15 (5th Cir. 1973); *Ehlen* v. *United States,* 323 F.2d 535, 540 (Ct. Cl. 1964); and *S. W. Coe & Co.* v. *Dallman,* 216 F.2d 566, 569 (7th Cir. 1954).[46] None of them involved, as here, the refusal of the Commissioner to give any credence to the uncollectibility of specific accounts which represented $184,000 of the $229,000 balance Thor determined as necessary for its bad debt reserve in 1965. In fact, this $184,000 exceeded the $136,000 addition to Thor's reserve for that year. Inasmuch as Thor's aging procedures added relatively small amounts to its reserve (Pet.Br. 16), Respondent's argument against the validity of aging is largely irrelevant (Resp.Br. 73).

Respondent concludes by purportedly distinguishing the principal cases relied upon by Thor, *Calavo, Inc.* v. *Commissioner,* 304 F.2d 650 (9th Cir. 1962), *rev'g* 19 T.C.M. (CCH) 1359, P-H TC Mem.Dec. 60-1507 (1960); *Travis* v. *Commissioner,* 406 F.2d 987 (6th Cir. 1969), *rev'g* 47 T.C. 502 (1967); and *Rhode Island Hospital Trust Co.* v. *Commissioner,* 29 F.2d 339 (1st Cir. 1928), *rev'g* 8 B.T.A. 555 (1927), on the ground that ". . . the taxpayers were able to demonstrate on the evidence

46. In *Atlantic Discount* the taxpayer relied on general economic conditions, industry-wide data, and the banking bad debt reserve standards of banks that loaned to it, to justify additions to its bad debt reserve necessary to maintain the reserve at 2.5% of outstanding receivables. Similarly in *Coe* the taxpayer relied on industry-wide bad debt loss data, general business conditions, and changes in the nature of its own business.

The taxpayer in *Ehlen* unsuccessfully defended its policy of maintaining reserves at 2.5% of credit sales by relying on recommendations made in a prior year by an agent of the Internal Revenue Service. It also challenged the Commissioner's disallowance of some of the taxpayer's bad debt chargeoffs. The case is therefore distinguishable, since no question has been raised concerning the propriety of Thor's bad debt chargeoffs.

that the Commissioner's recomputation of their bad debt reserve failed to consider all the facts and circumstances and thus constituted an abuse of discretion" (Resp.Br. 75).

Those cases all held that the Commissioner had abused his discretion because he refused to consider current data on the collectibility of the taxpayers' accounts receivable. The Commissioner, commencing with the audit, steadfastly has taken the position that the *Black Motor* formula determined the reasonableness of Thor's bad debt writeoff. With this viewpoint, the Commissioner obviously treated as irrelevant the facts and circumstances upon which Thor determined that several accounts totaling some $184,000 were uncollectible. The essence of the Commissioner's position is vividly demonstrated by the fact that he does not challenge the accuracy of Thor's evaluation of its accounts, yet insists on the *Black Motor* formula. In contrast to the cases cited by Thor, the courts below did not require the Commissioner to consider the "facts existing at the close of the taxable year of the proposed addition" as required by Regulation § 1.166-4(b)(1).[47]

CONCLUSION

The theme that pervades Respondent's brief—consistent with the opinions of the courts below—is the supremacy of the Commissioner's discretion. The Treasury Regulations are added to the balance when they putatively support him on the inventory issue, but are ignored when they are not helpful on the bad debt issue. As the *amicus* brief of the Chamber of Commerce of the United States pointed out (pp. 16-20), the Commissioner has not been required to follow the procedural safeguards

47. The Seventh Circuit's opinion does not examine the facts at all, but relies exclusively on the Commissioner's discretion (Pet. A-48). The Tax Court likewise eschewed the facts in favor of an inference that ". . . collectibility was probably more likely at the end of 1965 than it was in at least some of the years upon which the Commissioner based his average because new management had been infused into petitioner" (Pet. A-32). There is nothing whatsoever in the record suggesting that former management, whatever else its faults, did not try to collect its receivables.

imposed on other administrative agencies. In this case the lower courts have enlarged his already great discretion to an unprecedented degree, upholding his determination that Thor's valuation of its excess inventory in 1964 and of its accounts receivable in 1965 did not clearly reflect income, without requiring him to show how or why Thor's valuations were inaccurate or distorted its taxable income. Respondent vigorously endorses these extremes, even to the point of supporting the right of the Commissioner to amend Regulations in 1970 to retroactively invalidate a change of accounting procedures made by the taxpayer in 1964. "It seems a tacit slander of the Nation's credit that need for money should drive us to such casuistry as this." *Lykes* v. *United States,* 343 U.S. 118, 129 (1952) (Jackson, J. dissenting).

* * *

For the foregoing reasons, and those set forth in its initial brief, Thor respectfully requests this Court to reverse the judgment of the Court of Appeals for the Seventh Circuit on both the inventory and bad debt issues.

Respectfully submitted,

MARK H. BERENS,
LEE N. ABRAMS,
JOHN E. ALLEN,
DOUGLAS A. POE,
231 South LaSalle Street,
Chicago, Illinois 60604,
312-782-0600,
Attorneys for Petitioner,
Thor Power Tool Co.

Of Counsel:
MAYER, BROWN & PLATT

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR AMICUS CURIAE CHAMBER OF COMMERCE OF THE UNITED STATES IN SUPPORT OF REVERSAL

ALLAN B. MUCHIN
DONALD E. EGAN
FRANCIS X. GROSSI, JR.
ROBERT S. CONNORS
KATTEN, MUCHIN, GITLES
ZAVIS PEARL & GALLER
4100 Mid-Continental Plaza
55 East Monroe Street
Chicago, Illinois 60603
(312) 346-7400
Counsel for Amicus Curiae Chamber of Commerce of the United States

Of Counsel:
LAWRENCE B. KRAUS
General Counsel
Chamber of Commerce of the United States of America
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6036

STANLEY T. KALECZYC, JR.
Director of Litigation
National Chamber Litigation Center
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6218

Gunthorp-Warren Printing Company, Chicago • Financial 6-6565

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

Statutes

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR AMICUS CURIAE CHAMBER OF COMMERCE OF THE UNITED STATES IN SUPPORT OF REVERSAL

STATEMENT OF INTEREST

The Chamber of Commerce of the United States ("the Chamber") is a nonprofit corporation organized and existing under the laws of the District of Columbia. The Chamber is the largest business federation in the United States. Its membership consists of over 67,000 businesses, the great majority of which are corporations, and more than 3,700 state and local chambers of commerce and trade associations, which in turn have numerous corporate members. Many of these corporations are engaged in the manufacture or distribution of goods for which an inventory of replacement parts is an essential business practice.

The central issue in this case is one that has plagued the administration of the income tax laws since the day of their conception. It concerns, in the context of inventory valuation, reconciling established principles of financial accounting with the doctrine of the clear reflection of income, both of which are explicitly endowed with equal statutory authority. The Chamber seeks a definitive resolution of this pervasive and recurring issue to secure for its large membership of business taxpayers the benefits of certainty, precision and efficiency in the increasingly complex task of reporting taxable income.[1]

SUMMARY OF ARGUMENT

In recognition of the premise that financial accounting is devoted to the accuracy of period economic results, Congress has, since 1916, conferred upon proper accounting a decidedly influential effect upon the calculation of federal income taxes. Even more explicitly, this statutory preference for proper accounting has existed without interruption since 1918 with respect to inventory valuation.

Under this statutory scheme, the results of financial reporting in conformity with accepted accounting principles should be held to satisfy the demands of annual tax accounting. In addition to fulfilling the statutory preference for the best accounting procedures, the method of inventory valuation applied by the taxpayer here clearly reflects income. The dispositive element as it affects the income equation is realistic appraisal of the market value of ending inventory. The taxpayer relied upon objective business experience, validated by the scrutiny of accounting experts, to derive the expected return from its excess inventory. The requirements of actual market or closed transactions asserted by the Commissioner of Internal Revenue ("Commissioner") posit artificial and strained impediments that subvert overriding statutory and policy objectives.

1. The Chamber does not address the bad debt issue presented in this case.

In these circumstances, the statutory framework does not afford the Commissioner any broad discretion to simply set aside an accepted accounting rule. Where an accounting method and the accurate reporting of periodic financial results converge, as here, the method should be sustained even if predicated upon formulated estimates derived from business experience. Numerous rules of both financial and tax accounting are the function of reasonable economic assumptions, a factor which should confirm, rather than defeat, their shared objectives. In short, the sensible administration of the tax laws yields only the narrow authority of the Commissioner to disallow, under an appropriate standard, taxpayer's accounting method, or in a rare circumstance a prevalent accounting rule which demonstrably distorts income.

Finally, in discharging this statutory function, the administrative action of the Commissioner should adequately reveal the reasoning process to assure its substantive validity. Increasingly, this Court in varied administrative contexts has imposed the procedural duty upon the administrator to adequately explain governmental action for the purpose of exposing substantive policy and to assure an informed judicial review. There is no basis to excuse the Commissioner from these minimal requirements considering the scope and gravity of his discretionary determinations.

ARGUMENT

I. Congress Deliberately Chose Sound Accounting Methods as the Principal Calculus for Income Taxes

Following the constitutional authorization of the Sixteenth Amendment, Congress enacted in 1913 the first in a series of income tax codes, which was the rudimentary beginning for the present statute. Revenue Act of 1913, 38 Stat. 114. The original act imprecisely taxed "accrued" income which soon proved unworkable for lack of sufficient definition. Revenue Act of 1913, § IIB, 38 Stat. 167. *See generally* May, *Account-*

ing and the Accountant In the Administration of Income Taxation, 47 Col. L. Rev. 377 (1947).

With the extraordinary necessity for revenue and for a broad tax base prompted by the First World War, the Revenue Acts of 1916 and 1918 superseded the prior formula by adopting the general prescription that taxable income was to be computed in accordance with a taxpayer's regularly employed method of accounting, so long as income was not distorted. Revenue Act of 1916, § 13(d), 39 Stat. 756, 771; Revenue Act of 1918, § 212(b), 40 Stat. 1057, 1064-1065. This statutory tenet remains substantially unchanged in what is now Section 446[2] of the Internal Revenue Code of 1954.[3]

Of significance to this case, in passing the Revenue Act of 1918 Congress further declared that, with respect to inventory valuation, the method prescribed should conform as nearly as may be to the "best accounting practice in the trade or business and as most clearly reflecting the income." Revenue Act of 1918, Section 203, 40 Stat. 1060. These same standards have been in force for the last 60 years. See I. R. C. § 471.[4] The

2. Section 446 reads in relevant part as follows:

General Rule for Methods of Accounting.

"(a) General Rule.—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

"(b) Exceptions.—If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."

I. R. C. § 446.

3. Unless otherwise indicated, all section references in this brief are to the Internal Revenue Code of 1954, 26 U. S. C. §§ 1 *et seq.* (1970).

4. Section 471 reads in full as follows:

General Rule for Inventories.

"Whenever in the opinion of the Secretary or his delegate the use of inventories is necessary in order clearly to determine the

(Footnote continued on next page.)

legislative decision introduced in these provisions, and proposed by prominent accountants of the day, was an unmistakable acceptance of accounting principles designed to eliminate the confusion of prior tax laws. *See generally* May, *supra.*

Congress, of course, did not indiscriminately endorse every method of accounting at the sacrifice of the accurate depiction of income. The contrast of the language in Sections 446 and 471, however, is instructive in this regard. Under Section 446, a taxpayer's regular method of accounting may not be disturbed unless it distorts income, even though it is out of step with generally accepted accounting principles. Obviously, an accounting method, though regular, but nonetheless in conflict with an accepted accounting rule may indeed and often will misstate income. In that circumstance, the Commissioner can and should have the discretion to invoke a different method. The question remains, however, whether Congress ever intended to empower the Commissioner with the roving license to invalidate accounting methods that comply with accepted accounting principles dedicated to financial accuracy. In short, there is the fundamental question addressed herein of whether there is any distinction between realistic financial accounting and the clear reflection of income and, if so, how that distinction is determined and acted upon.

But apart from the precise interpretation of Section 446, Congress chose crucially different words for Section 471. As stated, the Commissioner was granted appropriate authority in Section 446 to supplant regular but unaccepted accounting methods to clearly reflect income. Beyond that, neither the statutory language nor the legislative history of Section 446

(Footnote continued from preceding page.)

income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

offer specific focus on the role of accepted accounting principles in the administrative process.[5] The Commissioner's authority under Section 471, however, is decidedly more confined in prescribing inventory valuation methods. The provision explicitly enjoins the Commissioner to devise a method that conforms both to the "best accounting practice"[6] and "as most clearly reflecting the income". The legislative history of Section 471, moreover, emphasizes a clear preference for accepted accounting standards as determinative except in instances of patent abuse.[7] While Section 471 may suggest some difference between best accounting and the clear reflection of income, it is manifest that the statute does not permit the Commissioner, with no explanation, to simply select one at the expense of the other. Equally important, there is every indication, as Part II demonstrates, that the method of inventory valuation employed by the taxpayer here does clearly reflect income, leaving the administrative determination with no substantive foundation.

II. An Inventory Valuation Method That Implements a Realistic Appraisal of Market Value Does Clearly Reflect Income

The income formula for a business with a physical inventory is critically affected by the method of ascribing value to the goods

5. In reenacting this provision in the 1954 Code, Congress did note:

> A method of accounting which reflects the consistent application of generally accepted accounting principles in a trade or business will ordinarily be considered as clearly reflecting income.

S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954), *reprinted in* [1954] U. S. Code Cong. & Ad. News 4939. *See also* Treas. Reg. 1.446-1(a)(2) (1957).

6. The phrase "best accounting practice" has been uniformly construed as equivalent to generally accepted accounting principles. *See, e.g., Space Controls, Inc.* v. *Commissioner,* 322 F. 2d 144, 151 (5th Cir. 1963).

7. *See* 61 Cong. Rec. (Part 6) 5809 (1921), quoted in relevant part in the Petitioner's Brief Part I.-A.

or material on hand at the end of a fiscal period. The ending inventory has a direct, inverse relation to reportable income.

A long settled precept of accounting, unequivocally adopted by the income tax regulations, states that ending inventory shall equal the lower of cost or market value. Treas. Reg. § 1.471-2 (c) (1958). The theoretical underpinning of this rule recognizes that a decline in the economic utility of goods available for sale is and should be attributed as a cost during the period in which the decline occurs. Even though the decline in value is unrealized by any transaction, the rule correctly assesses the economic fact that the operation is incurring a deficit to the extent a business produces goods during a given interval at a cost greater than expected return. If the rule failed to heed that reality, accounting would hardly fulfill its function of accurately informing a business of the economic results of its period activity.

Market value that expresses the dynamics of the marketplace has historically been a cardinal tradition for valuation of inventories in our tax framework. *See United States Cartridge Co.* v. *United States,* 284 U. S. 511 (1932). Adherence to this approach as commanded by relevant accounting standards is of signal importance in valuing excess inventory. In this case, the taxpayer had engaged in the common practice of producing multiple quantities of 44,000 individual replacement parts in excess of what subsequent experience demonstrated could be sold. This business decision was dictated by the inability to predict for each item the repair or replacement incidence. Concomitantly, the prohibitive cost of retooling for future supply dictated the excess production of replacement parts with the components of the integral product with which they are associated.

On this record, it is undisputed that the empirical business experience of this taxpayer demonstrated the inevitable fact that a large proportion of the entire inventory would never be sold. For this reason, there was abundant and uncontradicted testimony in the trial court that generally accepted accounting prin-

ciples required a writedown to net realizable value, that is, the amount of revenue reasonably expected from the disposition of these items. In the end, the accounting principle properly confirmed that this business incurred a measurable cost in producing an excess supply. That cost was the result of a deliberate and unavoidable business decision necessary to equip the enterprise with the ability to service the finished products it sold. Moreover, actual experience subsequent to the taxable years in issue furnished remarkable validity to the predicted value.[8] (A. 88-91.)[9] To ignore this period cost in the income equation would seriously misstate earnings.

Despite the demonstrated effort of the taxpayer and its accountants to reliably report the results of operations, the Commissioner and the Court of Appeals rejected taxpayer's method. First, the Court of Appeals recited a perceived but unarticulated distinction between tax and financial accounting as justification for its holding. (Pet. A. 40.)[10] This view is premised largely upon the supposition that financial accounting is dedicated to the balance sheet, a relic of a bygone era which the accounting profession has consistently repudiated. The rules of accounting and its practitioners have been increasingly sensitive to earnings, which is of foremost concern to shareholders, investors and other recipients of certified financial statements.[11] More important, it is one thing to say that, upon careful scrutiny and by objective standards, a given accounting rule fails to achieve income accuracy. It is quite another, as was the case here, to rely upon this litany of a difference without more to discard an accounting method designed to clearly reflect income.

Second, the Court of Appeals held that taxpayer's method was not authorized by the inventory regulations. (Pet. A. 41-45.) That holding, however, assumes a rigid and unyielding interpretation of the regulations while subverting the aims of the statute. Three Courts of Appeals confronted with the same issue in related contexts have each held that market realities, not a slavish construction, is the touchstone in applying the regulations. *Monfort of Colorado, Inc.* v. *United States*, 561 F. 2d 190 (10th Cir. 1977); *E. W. Bliss Co.* v. *United States*, 351 F. 2d 449 (6th Cir. 1965), *aff'g* 224 F. Supp. 374 (N. D. Ohio 1963); *Space Controls, Inc.* v. *Commissioner*, 322 F. 2d 144 (5th Cir. 1963).

As discussed in the taxpayer's brief filed herein (Pet. Br. Part I.-G.), the regulations provide examples rather than an exhaustive catalogue of market conditions. The Chamber will not repeat the cogent arguments of the taxpayer which show excess inventory is economically indistinguishable from unsalable goods described in the regulations. Suffice it to say that

8. Although the validity of an accounting method may not be sustained solely upon what occurs after the taxable year, such evidence is instrumental in evaluating the merits of the prediction:

> While subsequent events are not determinative of a fact on a given date prior thereto, that which occurred . . . confirms what would have been a reasonable expectation at that time. . . .

Space Controls Inc. v. *Commissioner*, 322 F. 2d 144, 155, n. 24 (5th Cir. 1963), *quoting Lucker* v. *United States*, 53 F. 2d 418, 424 (Ct. Cl. 1931).

9. "A." refers to the Appendix filed herein.

10. "Pet. A." refers to the appendix to the Petition in which the opinion of the Court of Appeals is reprinted.

11. The governing principles of accounting, adopted after extensive deliberation by the profession, have long ascribed paramount

(Footnote continued on next page.)

(Footnote continued from preceding page.)

consideration to the accuracy of period income. AICPA Accounting Principles Board Statement No. 4, "Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises", ch. 2, ¶ 12 (1970); AICPA Accounting Research Bulletin No. 43, "Introduction", ¶ 3 (1953).

With regard specifically to inventory valuation, the accounting principles compel selecting the method which "most clearly reflects periodic income." *Id.* ch. 4 at Statement 4, *and at* ch. 4, Statement 7.

To indiscriminately suggest, in light of the above, that generally accepted accounting principles and tax accounting do not share common objectives unfairly dismisses an entire body of considered judgment.

at worst, the regulations do not preclude taxpayer's method while the statute compels it.[12]

When the technical features of the regulations are put aside, the issue distills to whether taxpayer's method realistically calibrates market value. Nothing in the Commissioner's obscure determination, or in the views espoused by the Court of Appeals, raises serious question whether the inventory declined in value below its cost. At bottom, what is disputed is the method to measure that decline in value. The taxpayer relied upon undisputed business experience fortified by highly qualified accounting expertise. On the other hand, the Commissioner argued and the Court of Appeals agreed that the decline could only be realized by actual market transactions, including scrap sales. That reasoning defies analysis. If there had been an index of an open market for these parts, the decline in value would have been allowed without the formal necessity of realization or physical disposition. Yet, the unique characteristics of these parts by definition precluded an open market. To insist in this situation upon the formalistic and artificial act of attempted sales of these parts in the absence of any market effectively defeats the legitimate purpose of excess replacement parts with no corresponding benefit. In substance, the decision of the Court of Appeals in requiring a "closed transaction" is akin to contending that the only way of proving that a mushroom is not a toadstool is to eat it.

12. To the extent the regulations are deemed intractable as construed by the decision of the Court of Appeals, they necessarily collide with the relevant statute. Although the Chamber disagrees with the notion that there is no room in the regulations for taxpayer's method, it is clear that the regulations should be held invalid rather than elevated to a position superior to and in conflict with the statute upon which they depend.

III. The Relevant Statutes Circumscribe the Commissioner's Latitude to Displace an Established Accounting Rule

As heretofore demonstrated, the accounting rule at stake here is not only generally accepted in the field of expertise, but it stands on its own merits as the best empirical index of the peculiar market for replacement parts. Accordingly, it amply satisfies the command of the relevant statutes as a method that clearly reflects income while constituting the best accounting practice.

The administrative determination in this case posits the question of whether and to what extent Congress ever intended to grant the Commissioner discretion to disallow an established accounting principle solely because, in the Commissioner's judgment, it distorts income. This issue was raised but not definitively resolved in this Court's decisions in *American Automobile Ass'n.* v. *United States,* 367 U. S. 687 (1961) (hereafter cited as *"AAA"*) and *Schlude* v. *Commissioner,* 372 U. S. 128 (1963), both of which involved the application of Section 446.

Prior to those decisions, the statutory predecessors of Section 446 had a varied history in the courts. Several decisions by this Court and by lower courts effectively equated realistic accrual accounting with acceptable tax reporting, particularly with respect to expenses. *See, e.g., Continental Tie & Lumber Co.* v. *Commissioner,* 286 U. S. 290 (1932); *United States* v. *Anderson,* 269 U. S. 422 (1926); *Denise Coal Co.* v. *Commissioner,* 271 F. 2d 930, 934-937 (3d Cir. 1959); *Pacific Grape Products Co.* v. *Commissioner,* 219 F. 2d 862 (9th Cir. 1955); *Uncasville Manufacturing Co.* v. *Commissioner,* 55 F. 2d 893, 895 (2d Cir. 1932), *cert. denied,* 286 U. S. 545 (1932). While there was an occasional reference to financial and tax accounting, the decisions disallowing a taxpayer's accounting invariably found it wanting in reliability or accuracy. *See, e.g., Automobile Club of Michigan* v. *Commissioner,* 353 U. S. 180 (1957); *Lucas* v. *Kansas City Structural Steel Co.,* 281 U. S. 264 (1930); *Lucas* v. *American Code Co.,* 280 U. S. 445

(1930). Indeed, the pattern of decisions is consistent with a reading of Section 446 that limits the Commissioner to disallowing a taxpayer's accounting which distorts income by departing from the same principles followed by established accounting.

Against this historical backdrop, the taxpayers in *AAA* and *Schlude* sought to defer prepaid income for services by spreading the receipts ratably over the period when the services were to be performed for the customer. The taxpayer's method was conceded to be in accord with generally accepted accounting principles. A five to four majority of the Court in both cases upheld the Commissioner's discretionary disallowance upon two grounds. First, the Court found that, since customer demand for future service was potentially erratic, allocating income ratably in the future was an "artificial" accounting method vulnerable to the Commissioner's discretion. *AAA,* 367 U. S. at 690-694; *Schlude,* 372 U. S. at 135-137. The second ground of the decisions, which the Court concluded firmly supported the first, was the enactment and subsequent repeal within one year of Sections 452 and 462 of the Internal Revenue Code of 1954.[13] *AAA,* 367 U. S. at 694-698; *Schlude,* 372 U. S. at 134-135. In particular, Section 452 would have permitted the precise tax accounting which taxpayers sought in *AAA* and *Schlude. AAA,* 367 U. S. at 694. Surveying the ambiguous legislative history of this short-lived statute, the Court in *AAA* and *Schlude* discerned a congressional decision to segregate this issue for further legislative consideration and action.[14]

13. 26 U. S. C. §§ 452, 462 (1952 ed. Supp. II), repealed 69 Stat. 134 (1955).

14. In enacting Section 452, Congress expressed its disapproval of court decisions which generated disparity and confusion between financial and tax accounting. *See* H. R. Rep. No. 1337, 83d Cong., 2d Sess. 48, *reprinted in* [1954] U. S. Code Cong. & Ad. News 4073. That general intent of Congress to promote uniformity of financial and tax accounting was not dissipated by the repeal of Section 452. For even under the majority opinion in *AAA*, that repeal simply reflected a legislative decision to isolate prepaid income for further Congressional action.

Because of the exceptional legislative measures respecting prepaid income, the implications of *AAA* and *Schlude* should be confined to that discrete area.

To the extent that the majority opinions in *AAA* and *Schlude* promote the notion that an accounting method predicated upon reasonable estimates derived from business experience may be undone in the Commissioner's discretion, that proposition should not be extended beyond the facts of those cases. Hardly a rule of accounting exists, whether it be dubbed tax or financial, that does not depend upon an accurate assessment of past events as the basis for assaying the future. In the area of bad debts, depreciation, worthless stock, accrual income, to name a few, accrual tax consequences are essentially estimates based upon historical evidence. The ideals of certainty and reliability in our self-assessment system are too elemental to permit developed procedures of measure to be swept aside in favor of unfettered administrative power.[15]

In a subsequent prouncement of the relation between tax and financial accounting, this Court held that despite *AAA* and *Schlude* generally accepted accounting principles are not to be lightly displaced. *Commissioner* v. *Idaho Power Co.,* 418 U. S. 1 (1974). In *Idaho Power Co.,* the taxpayer was urging tax treatment at odds with established accounting rules which were also imposed by the Federal Power Commission to which the taxpayer was subject. This Court noted with respect to *AAA*:

> In . . . [AAA] it was observed that merely because the method of accounting a taxpayer employs is in accordance

15. The fact that the taxpayer here found it impractical or impossible to separately evaluate the oversupply factor for each of 44,000 parts is inconsequential. With respect to the analogous situation of pinpointing accrued liabilities, courts have held that a deduction will be allowed for a group of liabilities analysed as a whole even though individual liabilities could not be identified. *Lukens Steel Co.* v. *Commissioner,* 442 F. 2d 1131 (3d Cir. 1971); *Washington Post Co.* v. *United States,* 405 F. 2d 1279 (Ct. Cl. 1969). In both those cases, a deduction for an employee benefit fund was allowed even though the amount of the fund was statistically estimated and the identity of the particular recipients and the time of payment was yet to be fixed. *See also Gillis* v. *United States,* 402 F. 2d 501 (5th Cir. 1968).

> with generally accepted accounting principles, this "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury". . . . Nonetheless, where a taxpayer's generally accepted method of accounting is made compulsory by the regulatory agency *and* that method clearly reflects income, it is almost presumptively controlling of federal income tax consequences.

Commissioner v. *Idaho Power Co.*, 418 U. S. at 15 (emphasis in original; citations omitted.) Although the business of the taxpayer in this case is not generally subject to the same broad regulatory scheme as a public utility, its publicly disseminated income reports are subject to financial disclosure rules of the Securities and Exchange Commission. The SEC has traditionally required registrants to adhere to established accounting principles and has further declared that unsubstantiated deviations would be deemed presumptively "misleading". *See* Securities & Exchange Commission Accounting Series Release No. 4 (April 25, 1938); Securities & Exchange Commission Accounting Series Release No. 150 (December 20, 1973). What is more, a contrast with *Idaho Power Co.* illustrates the harsh anomoly of the Commissioner's position here in seeking to create a vast discretionary domain to freely accept or reject established accounting rules whenever a revenue advantage is perceived. That result does sharp violence to the inventory statute which uniquely places the value of best accounting on the same plane as the clear reflection of income.

Most recently in *Frank Lyon Co.* v. *United States*, ... U. S. ...., 46 U. S. L. W. 4313 (U. S. April 18, 1978), this Court considered the effect of the taxpayer's adherence to accepted accounting principles in assessing the Commissioner's contention that a sale-and-leaseback lacked economic substance. The parties' uniform adherence, the Court observed, "gave the transaction a meaningful character consonant with the form it was given." 46 U. S. L. W. at 4318. This Court did not suggest in *Lyon*, nor does the Chamber contend here, that adherence to generally accepted accounting principles is necessarily dispositive. Rather, the critical point is that tax reporting which adheres to accounting conventions should enjoy protection from undefined administrative discretion in the absence of a contrary statute or of a distortion of income clearly articulated by the Commissioner.

In this case measuring a decline in inventory value under the Commissioner's disallowance would exchange a practical, recognized rule for the ritual of scrapping the disputed items. Indeed, the Commissioner's near-sighted insistence in detaining the loss until excess inventory is physically discarded portends the very abuse his position avows to curb. At the time when a taxpayer could individually identify the unneeded replacement parts, the loss by scrapping could be incurred or postponed to maximize tax advantages, irrespective of any compunction to clearly reflect income. The irony of that result would be a loss of both the certainty sought by taxpayers and the revenues sought by the Commissioner.

In sum, this Court should restore to this case the abiding congressional intent since 1916 which denies the Commissioner any discretion to disturb a taxpayer's reported income if executed in accordance with realistic accounting procedures. This Court should further hold that generally accepted accounting principles constitute realistic accounting procedures unless the Commissioner can explain and show that a particular established rule has an objective and result that conflict with period income. Such a decision does not require an act of faith, for it is recognized that accounting, like every other human endeavor, is not an absolute or perfect science. As one astute commentator has stated:

> The enactment of Section 212[16] of the Revenue Act of 1918 and the discussions to which it gave rise undoubtedly

16. Section 212 is the predecessor of Section 446 of the present Code.

> contributed to a wider recognition of the fact that accounting is not an exact science based on inexorable laws, but a method of analysis and classification based on postulates and conventions which leads to conclusions the merit of which is that they are useful and indeed almost essential in the conduct of business.

May, *Accounting and the Accountant in the Administration of Income Taxation,* 47 COL. L. REV. 377, 387 (1947).

A pronouncement by this Court, which rightfully grants to established accounting rules the probity intended by Congress, would provide the stability Justice Jackson found deplorably wanting in another setting:

> [C]onflicts are multiplied by treating as questions of law what really are disputes over proper accounting. The mere number of such questions and the mass of decisions they call forth become a menace to the certainty and good administration of the law.

Dobson v. *Commissioner,* 320 U. S. 489, 499 (1943). *Accord, Brown* v. *Helvering,* 291 U. S. 193, 204-205 (1934) ("It is not the province of the court to weigh and determine the relative merits of systems of accounting.")

In short, this case presents the profound policy choice of whether certainty, precision, and clarity in the administration of the tax laws is more important than affording the tax administrator the awesome power to disarrange accounting systems for no other reason than to enlarge the revenues.

IV. The Commissioner's Exercise of Discretion Should Be Subject to Procedural Safeguards

However the Commissioner's discretion is defined, it is untenable that it should be exercised with no procedural safeguards calculated to assure substantive content. In this case, after an elaborate administrative process and upon reaching the Tax Court, this enormous adjustment by the Commissioner was explained in a cursory statement. (A. 3.) In the Tax Court, no

evidence was offered by the Commissioner, much less any criteria of what constitutes the clear reflection of income. (A. 207.) As a result, the Tax Court's holding on this central issue was, as the Court of Appeals candidly but uncritically noted, "without elaboration." (Pet. A. 41.) Indeed, the only justification for the Commissioner's action in all these proceedings including in his opposition to a writ of certiorari in this Court has consisted solely of the rationalization of government counsel.[17]

Increasingly, this Court and the Courts of Appeals in reviewing a wide variety of administrative action have imposed minimum procedural requirements upon the several federal agencies. As demonstrated below, these requirements have been formulated whether or not the Administrative Procedure Act[18] was applicable and despite how broad the agency's discretion and how lean the judicial review of it.[19] What is curious is how the Commissioner has apparently managed to escape these strictures when considering, as Chief Justice Marshall suggested,[20] that the power to dip into a taxpayer's pocketbook can be as devastating as any governmental action. Moreover, like any other federal agency, the Commissioner is but a surrogate of Congress where the constitutional power resides.

17. Even then, the government has chiefly asserted that a wooden construction of the regulations at odds with market realities and dominant statutory objectives should ordain the outcome here.

18. 5 U. S. C. §§ 551, *et seq.* (1970).

19. *See generally,* K. DAVIS, ADMINISTRATIVE LAW OF THE SEVENTIES, ch. 16, pp. 377 *et seq.,* Supplement, ch. 16, pp. 133 *et seq.* (1976). As Professor Davis has noted, the Administrative Procedure Act is essentially a codification of prior (and still valid) decisional law principally of this Court.

20. "[T]he power to tax involves the power to destroy . . ." *McCulloch* v. *Maryland,* 17 U. S. 316, 431 (1819). The eloquent modification of that aphorism by Justice Holmes is perhaps more fitting here:

> The power to tax is not the power to destroy while this Court sits.

Panhandle Oil Co. v. *Mississippi,* 277 U. S. 218, 223 (1928) (dissenting opinion).

On repeated occasions in differing administrative settings, this Court and lower courts have insisted that an agency furnish an adequate explication of its action. *See, e.g., Dunlop* v. *Bachowski*, 421 U. S. 560, 571-577 (1975) (Secretary of Labor required to give reasons for refusing to institute action to set aside union election); *Wolff* v. *McDonnell*, 418 U. S. 539, 564-565 (1974) (prison officials required to give reasons for disciplinary action); *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U. S. 402 (1971) (Secretary of Transportation required to give reasons for highway route selection); *Kitchens* v. *Department of the Treasury*, 535 F. 2d 1197 (9th Cir. 1976) (Bureau of Alcohol, Tobacco and Firearms required to give reasons for denying application for relief from federal disabilities); *Beck* v. *Securities & Exchange Commission*, 413 F. 2d 832 (6th Cir. 1969) (Securities and Exchange Commission required to give reasons for severity of sanctions imposed for broker's misconduct). These decisions were not premised upon any statutory mandate of the APA. Rather, an explanation of agency action has been found to be indispensable to effective judicial review, even if such review is narrow in scope. *See Dunlop* v. *Bachowski*, 421 U. S. 560, 571-577 (1975); *Panama Refining Co.* v. *Ryan*, 293 U. S. 388, 432-433 (1935). Perhaps more critical, the reasons for an agency's policy may assume greater importance than the policy itself:

> [T]he public is vitally concerned with the reasons which did supply the basis for an agency policy actually adopted.

NLRB v. *Sears, Roebuck & Co.*, 421 U. S. 132, 152-153 (1975).

In view of the primacy of these considerations, an agency determination devoid of any articulated basis of reasons cannot be sustained by "*post hoc* rationalizations" of its counsel, *FPC* v. *Texaco, Inc.*, 417 U. S. 380, 397 (1974), or by the creative guesswork of the courts, *Bowman Transportation, Inc.* v. *Arkansas-Best Freights System, Inc.*, 419 U. S. 281, 285-286 (1975). Even under the "arbitrary and capricious" standard of

review, "[t]he agency must articulate a 'rational connection between the facts found and the choice made.'" *Id.* at 285, *quoting Burlington Truck Lines* v. *United States*, 371 U. S. 156, 168 (1962).

There is no reason for the Internal Revenue Service to be exempted from these precepts, for administrative action of the magnitude involved in this case should be exposed to sunlight. The District of Columbia Court of Appeals identified these evolving policies of administrative law which aptly fit the administrative exercise of the taxing power:

> We stand on the threshold of a new era in the history of the long and fruitful collaboration of administrative agencies and reviewing courts. For many years, courts have treated administrative policy decisions with great deference, confining judicial attention primarily to matters of procedure. On matters of substance, the courts regularly upheld agency action, with a nod in the direction of the "substantial evidence" test, and a bow to the mysteries of administrative expertise. Courts occasionally asserted, but less often exercised, the power to set aside agency action on the ground that an impermissible factor had entered into the decision, or a crucial factor had not been considered. Gradually, however, that power has come into more frequent use, and with it, the requirement that administrators articulate the factors on which they base their decisions.

Environmental Defense Fund, Inc. v. *Ruckelshaus*, 439 F. 2d 584, 597 (D. C. Cir. 1971) (footnotes omitted). The court further delineated minimal requirements to assure basic administrative fairness which this Court should hold applicable to the Commissioner's determination here:

> To protect these [societal] interests from administrative arbitrariness, it is necessary, but not sufficient, to insist on strict judicial scrutiny of administrative action. For judicial review alone can correct only the most egregious abuses. Judicial review must operate to ensure that the administrative process itself will confine and control the

> exercise of discretion. Courts should require administrative officers to articulate the standards and principles that govern their discretionary decisions in as much detail as possible. Rules and regulations should be freely formulated by administrators, and revised when necessary. Discretionary decisions should more often be supported with findings of fact and reasoned opinions. When administrators provide a framework for principled decision-making, the result will be to diminish the importance of judicial review by enhancing the integrity of the administrative process, and to improve the quality of judicial review in those cases where judicial review is sought.

Id. at 598 (footnotes omitted). Unless the Commissioner is obliged to detail the reasons for his discretionary acts, there is no way to ascertain whether salient tax policies have been motivated by a principled analysis, by a crass tally of the revenues, or by other extraneous considerations.[21]

CONCLUSION

In 1916 Congress wisely chose to incorporate realistic accounting practices in tax determinations, particularly in respect to inventories. While Congress also conferred appropriate authority upon the Commissioner to fairly fill the interstices of the law, it conferred no power to impose dictates contrary to the overriding policy and statutory objectives.

The Code, after all, is intended to tax real not imaginary financial success. The cost of producing excess inventory parts is no more or less a reasonable estimate of financial fact than the economic assumptions that underly many facets of every tax return. An accounting method that relies and acts upon the

21. The Tax Court, while acquiring more the characteristics of a constitutional court than its original status as an administrative tribunal, does often satisfy the policy of providing stated reasons for tax regulation. However, as the opinion of the Tax court here emphasized (Pet. A. 20-21, 30), it merely conducted a limited judicial review of the inventory issues under a "plainly arbitrary" standard, in deference to the Commissioner's assertedly "broad" discretion.

solid realities of business experience deserves far greater efficacy than was extended in this case.

In behalf of its constituency comprising business taxpayers of every size and description, the Chamber urges this Court to instill confidence and stability in the tax framework by pronouncing a result which affirms the value of established methods of period accounting rather than one which subordinates those methods to the unspoken motives of administrative power.

For all the foregoing reasons, the judgment of the Court of Appeals should be reversed.

Respectfully submitted,

ALLAN B. MUCHIN
DONALD E. EGAN
FRANCIS X. GROSSI, JR.
ROBERT S. CONNORS
KATTEN, MUCHIN, GITLES, ZAVIS PEARL & GALLER
4100 Mid-Continental Plaza
55 East Monroe Street
Chicago, Illinois 60603
(312) 346-7400
Counsel for Amicus Curiae Chamber of Commerce of the United States

Of Counsel:
LAWRENCE B. KRAUS
General Counsel
Chamber of Commerce of the United States of America
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6036

STANLEY T. KALECZYC, JR.
Director of Litigation
National Chamber Litigation Center
1615 H Street, N. W.
Washington, D. C. 20062
(202) 659-6218

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF AMICUS CURIAE OF THE NATIONAL ASSOCIATION OF MANUFACTURERS OF THE UNITED STATES OF AMERICA

INTEREST OF THE AMICUS CURIAE[1]

CRANE C. HAUSER
ARTHUR I. GOULD
One First National Plaza
Suite 5000
Chicago, Illinois 60603
312-786-5600
RICHARD D. GODOWN
General Counsel
JOHN LUCAS
Associate General Counsel
National Association of Manufacturers
1776 F Street, N.W.
Washington, D.C. 20006
202-331-3700
Attorneys for the National Association of Manufacturers of the United States of America,
Amicus Curiae

Of Counsel:
WINSTON & STRAWN

La Salle Street Press — Chicago Printed in U.S.A.

[1] This brief is filed with the written consent of the parties pursuant to Supreme Court Rule 42(2). Letters of consent are on file with the Clerk of this Court.

IN THE

Supreme Court of the United States

October Term, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF AMICUS CURIAE OF THE NATIONAL ASSOCIATION OF MANUFACTURERS OF THE UNITED STATES OF AMERICA

INTEREST OF THE AMICUS CURIAE[1]

The National Association of Manufacturers of the United States of America ("NAM"), a New York corporation not for profit, is an organization exempt from Federal income taxation under Section 501(c)(6) of the Internal Revenue

[1] This brief is filed with the written consent of the parties pursuant to Supreme Court Rule 42(2). Letters of consent are on file with the Clerk of this Court.

Code of 1954 ("the Code") as a business league. It is a trade association which represents the common business interests of more than 12,000 manufacturing corporations.

A very substantial number of the members of the NAM value their inventories under the valuation method known as "cost or market, whichever is lower," which method is specifically authorized under Treasury Regulations § 1.471-4, and have for many years written down the value of their inventories to reflect the presence of "excess inventories," i.e., inventories held in quantities exceeding those which can be sold, as required to comply with generally accepted accounting principles.

These write-downs of excess inventories, which are required in order to obtain an income statement certified by a certified public accountant, and thus also required by the Securities and Exchange Commission under Section 19(a) of the Securities Act of 1933, have for many years been allowed by the Internal Revenue Service in the computation of taxable income.

The issue in this case to which this brief is directed is whether the Commissioner of Internal Revenue ("the Commissioner") has the discretion under Code § 471 to disallow such write-downs and require that excess inventories be carried at cost for tax purposes until they are scrapped, based solely upon his unsupported assertion that such write-downs do not clearly reflect income.

Should the Seventh Circuit's decision[2] in this case not be reversed by this Court, members of the NAM, as well as many other taxpayers engaged in manufacturing and non-manufacturing activities, will be adversely and substantially affected.

[2] *Thor Power Tool Co.* v. *Commissioner of Internal Revenue*, 563 F. 2d 861 (7th Cir., 1977).

The imposition of extensive retroactive tax liabilities[3] upon income which will never be realized will result either in heavy financing costs or in uneconomical scrapping of inventories, either of which will cause substantial and unnecessary price increases.

SUMMARY OF ARGUMENT

The method of accounting for excess inventories by Thor Power Tool Co. ("Thor") represented the "best accounting practice" in its business, under Code § 471, and the Commissioner's action in rejecting this method, without explanation, as not clearly reflecting Thor's income, and in substituting a method clearly distortive of income, was arbitrary and unlawful.

[3] By the reversal of all prior write-downs on excess inventories existing in years open under the statute of limitations.

ARGUMENT

It is undisputed in this proceeding that Thor's method of accounting for excess inventories was in accordance with generally accepted accounting principles and represented the "best accounting practice" in its trade or business, within the meaning of Code § 471.[4] It is also clear that the intention of Congress, followed for many years by the Treasury Department under its regulations, was that an inventory method which represented the "best accounting practice" in a business would be accepted as being clearly reflective of income under Code § 471.[5]

In view of these undisputable conclusions, it is astonishing that the courts below saw fit to hold that the Commissioner of Internal Revenue was free to disregard Thor's inventory valuation by a naked assertion that it did not clearly reflect income.

The Tax Court attempted to soften this appearance of untrammeled discretion by asserting that Thor's write-downs of excess inventories were arbitrary,[6] in the face of uncontradicted expert testimony of certified public accountants and experienced management that they were not.

The Court of Appeals attempted to do the same by unearthing an "inference" in the Tax Court opinion that Thor had been inconsistent in the use of its method.[7]

Despite these attempts to soften the arbitrary nature of the action taken here by the Commissioner, the end result of the holdings below, if allowed to stand, is that, in the

[4] *Thor Power Tool Co.* v. *Commissioner,* 563 F. 2d at 867.

[5] Pet. Br. 31-35.

[6] *Thor Power Tool Co.,* 64 T.C. 154 (1975), at 170.

[7] *Thor Power Tool Co.* v. *Commissioner,* 563 F. 2d at 868.

highly significant area of inventory valuation, the power of the Commissioner to accept or reject inventory methods would be absolute and not subject to review. He need not explain why a method of inventory valuation in accordance with generally accepted accounting principles and constituting the best accounting practice fails to clearly reflect taxable income; he needs only to say that the method is unacceptable.

The absence of any expressed rationale for the Commissioner's determination is understandable. There is none. As pointed out in Petitioner's brief,[8] the valuation of excess inventories at cost until they are scrapped results in distortion, rather than in clear reflection of income. Indeed, when the Commissioner, after almost 60 years of silence (and twelve days after the decision of the Court of Appeals below), finally took a published position regarding percentage write-downs of excess inventories, he gave no reasoned explanation of his position, but merely referred to a series of irrelevant provisions in the regulations under Code § 471, and concluded the method was unacceptable. Rev. Rul. 77-364, I.R.B. 1977-41, p. 9.

If all that is required of the Commissioner to reject an inventory method which is in accordance with generally accepted accounting principles and is the best accounting practice is silence in the regulations, it is submitted that the concern of the NAM is justified.

This Court recently held, in *Central Illinois Public Service Company* v. *United States,* No. 76-1058, February 28, 1978, that the Commissioner could not retroactively impose upon employers a liability to withhold income taxes on reimbursements of luncheon expenses of employees where,

[8] Pet. Br. 55-56.

in the tax year in issue, "not one regulation or ruling required withholding on any travel expense reimbursement," and where no employer, in viewing the regulations, "could reasonably suspect that a withholding obligation existed." While the need for precise rules in the area of withholding tax liability may be greater than in the general area of income tax liability, it is submitted this this Court's concern regarding administrative inaction in that case should be equally applicable to an area of as widespread importance as inventory valuation methods.

It is interesting in this connection to compare the inaction of the Commissioner in this case with the reasoned actions taken in connection with the so-called "base stock" method of inventory valuation, whose rejection by the Commissioner was approved by this Court in *Lucas* v. *Kansas City Structural Steel Co.,* 281 U.S. 264 (1930).[9]

In 1919, a Treasury ruling, Tax Board Ruling No. 65, 1 C.B. 51, was published, explaining at length why the "base stock" method was not acceptable under the predecessor of Code § 471, as being distortive of income and not in accord with the "best accounting practice". The 1922 version of Regulations 45 next specifically prohibited the use of the method.[10] On the basis of the ruling, a discussion of the annual distortive operation of the "base stock" method, and the fact that the taxpayer "disclaims any defense of the base stock method", this Court stated that the method "does not conform with the general or best accounting methods and is apparently obsolete." Small wonder that the Court concluded that the taxpayer had not met "the heavy burden of proving that the Commissioner's action was plainly arbitrary."

[9] The only decision of this Court relating to methods of valuation of inventories under Code § 471.

[10] Regs. 45, Art. 1582 (as amended by T.D. 3296, March 3, 1922).

Here, on the other hand, we have an inventory method which is in accordance with generally accepted accounting principles, rejected out of hand by the Commissioner after almost 60 years of silence. There can be no presumption of correctness to such administrative caprice.

References by the courts below to the "prepaid income" cases of *American Automobile Association* v. *United States,* 367 U.S. 687 (1961), and *Schlude* v. *Commissioner,* 372 U.S. 128 (1963), as sanctioning departures by the Commissioner from generally accepted accounting principles are inappropriate here.

Code § 471 was not involved in those cases. What was involved there was Code § 446(b), the general provision regarding methods of accounting, in the context of the enactment by Congress of Code § 452, permitting the deferral of prepaid income, and its abrupt repeal. The statutory history regarding the treatment of prepaid income was thus one of concern and confusion, rather than one of a clear congressional mandate, as here. There was there no long history of acquiescence by the Commissioner in the taxpayers' treatment of prepaid income, but rather a long history of dispute.

These cases hold only that Congress' abrupt repeal of Code § 452 gave legislative sanction to the Commissioner's disregard of generally accepted accounting principles as to prepaid income. They provide no authorization for the Commissioner to do so here.

Whether one characterizes the Commissioner's exercise of discretion here as arbitrary or merely unreasoned, it is urged that this Court should hold that Code § 471 does not sanction so blithe a disregard of the principles fashioned by the accounting profession. Absent such a holding, the rules of tax accounting will become a house built on sand.

CONCLUSION

The judgment of the court below, which, contrary to Code § 471, confers an unlimited discretion upon the Commissioner to disregard generally accepted accounting principles of inventory valuation, is not only incorrect, but will result in an unconscionable retroactive financial burden for American business. The NAM urges this Court to reverse that judgment.

Respectfully submitted,

Crane C. Hauser
Arthur I. Gould
One First National Plaza
Suite 5000
Chicago, Illinois 60603
312-786-5600
Richard D. Godown
General Counsel
John Lucas
Associate General Counsel
National Association of Manufacturers
1776 F Street, N.W.
Washington, D.C. 20006
202-331-3700
Attorneys for the National Association of Manufacturers of the United States of America, *Amicus Curiae*

Of Counsel:
Winston & Strawn

CERTIFICATE OF SERVICE

I hereby certify that on May 19, 1978, I served three copies of this Brief for the National Association of Manufacturers of the United States of America, as *Amicus Curiae,* upon each of the parties to this proceeding by depositing the same, enclosed in a sealed envelope with first class postage thereon fully prepaid, in a United States mail box at Chicago, Illinois, addressed to the attorneys for the parties as follows:

Mark H. Berens
Lee N. Abrams
John E. Allen
Douglas A. Poe
Suite 1955
231 South LaSalle Street
Chicago, Illinois 60604

Honorable Wade Hampton McCree, Jr.
Solicitor General of the United States
U.S. Department of Justice
Washington, D.C. 20530

Arthur I. Gould
Attorney for the National Association of Manufacturers of the United States of America.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-920

THOR POWER TOOL, CO.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STAT COURT OF APPEALS FOR THE SEVENTH CIRCU

Brief of the Taxation With Representation Fund and the Tax Reform Research Group as *Amici Curiae* in Support of Respondent

Calvin H. Johnson,
School of Law,
Rutgers, The State University,
15 Washington Street,
Newark, New Jersey 07102
(201) 648-5687

Eric Neisser,
School of Law,
Rutgers, The State University,
15 Washington Street,
Newark, New Jersey 07102
(201) 648-5687

Attorneys for Amici Curiae

N.J. Appellate Printing Co., Inc., So. Plainfield, New Jersey (201) 753-0200

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

TABLE OF CONTENTS

AUTHORITIES CITED:

TABLE OF CONTENTS

AUTHORITIES CITED:

TABLE OF CONTENTS

IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1977

No. 77-920

THOR POWER TOOL CO.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Brief of the Taxation With Representation Fund and of the Tax Reform Research Group, *Amici Curiae*, in Support of Respondent

INTEREST OF AMICI CURIAE*

The Taxation With Representation Fund is a non-profit corporation organized under the laws of the District of Columbia to provide legal representation for the public interest in tax cases and to provide news and current analysis of legislative and administrative tax issues for tax

* This Brief on behalf of Amici Curiae is filed with the written consent of the parties pursuant to Supreme Court Rule 42(2). Letters of consent are on file with the Clerk of this Court.

practitioners, journalists and the public. The Fund publishes *Tax Notes: The Journal of Policy Relevant Tax Analysis*, a weekly periodical to make tax information available to the news media and public. Its Special Reports have provided policy analysis by leading tax lawyers and public finance economists of current tax issues since 1970 and its features convey news of Congress, the Internal Revenue Service and the courts. The Fund also conducts a public interest law practice on tax issues within the guidelines established by the Internal Revenue Service for public interest law firms. I.R.S. Technical Information Release 1348 (February 19, 1975). The Fund is a tax exempt charity under section 501(c)(3) of the Internal Revenue Code and has such broad public support that it qualifies as a public charity and not a private foundation under section 509(a) of the Code. The Taxation With Representation Fund was founded (under its former name Tax Analysts and Advocates) in 1970 and draws continuing public support in pursuit of the goals, including the following:

> To ensure that ordinary citizens are represented effectively when important tax decisions are made
>
> To counter the influence and power of special interest lobbies and their domination of important aspects of the tax policy process
>
> To ensure that the tax decision process respects basic canons of rational debate
>
> To present for decision by the courts important tax questions that would not otherwise be litigated. The Taxation With Representation Fund, *Description, Budget and Funding Request 1975-1980.*

The Tax Reform Research Group is a division of Public Citizens, Inc., a nonprofit corporation organized

under the laws of the District of Columbia. Public Citizen is supported by 175,000 members through $15 annual dues and is a tax exempt organization under section 501(c)(4) of the Internal Revenue Code. The Tax Reform Research Group is composed of 4 lawyers and supporting staff whose function is to work for reform of the Federal, state and local tax laws in the interest of the average taxpayer and for the improvement of the administration of existing laws. The staff lawyers of the Group have frequently testified before the House Ways and Means and Senate Finance Committees on tax legislation and have worked with various members of Congress on tax legislation. On state and local tax issues, it serves as a clearing house for information which local groups use in their efforts for tax reform. The Tax Reform Research Group was founded in 1971 by Ralph Nader.

The Taxation With Representation Fund and the Tax Reform Research Group of Public Citizen, Inc. offer this brief as *amici curiae*, within the scope of their articulated goals and within the scope of their long standing activities toward improvement of the Federal tax system and to prevent the shifting of the given Federal tax burden to ordinary citizens like the supporters of The Taxation With Representation Fund and like the members of Public Citizen. Such shifting would occur if some taxpayers avoided paying their fair share of the tax burden through abuses such as the inventory write down which petitioner herein has claimed. *Amici* here support respondent, Commissioner of Internal Revenue, in seeking affirmance of the decision of the Court of Appeals for the Seventh Circuit.

QUESTION DISCUSSED BY AMICI CURIAE

Are undervaluations of intentionally overproduced inventory binding on the Commissioner of Internal Revenue and the Courts for tax purposes merely because the valuations are reported on financial books prepared within the range of generally accepted accounting principles?

ARGUMENT

I. It is the responsibility of the Commissioner of Internal Revenue and the Courts to decide issues concerning the definition of taxable business income, including tax accounting issues. Financial books, including those prepared within the range of generally accepted accounting principles are not binding on the Commissioner or the Courts for tax purposes.

The term "tax accounting" has traditionally been applied to issues dealing with the timing of taxable business income and deductions. Timing is integral to and as important as other aspects of defining taxable income. Deferral of taxable income is as valuable to a taxpayer as are tax exclusions or drastic rate reductions.[1] Thus, it is more accurate to use the term "tax accounting" for all the tax issues in the area in which professional accountants work, that is, the determination of business income. While Congress has specified many details of taxable business income, other tax accounting issues come to the courts under such general tests that the courts have developed and relied on what amounts to a common law of tax accounting.[2] The jurisprudence defining business tax-

1. Good explanations of the importance of tax timing and the value of deferral are found in Surrey, The Tax Reform Act of 1969—Tax Deferral and Tax Shelters, 12 B.C. Inc. Comm. L. Rev. 307 (1971) and Andrews, A Consumption-Type or Cash Flow Personal Income Tax, 87 Harv. L. Rev. 1113, 1123-1128, 1136-1139, 1181-1183 (1974). See also Cohen, Accounting for Taxes, Finance and Regulatory Purposes—Are Variances Necessary? 44 Taxes 780, 782 (1966). (Because business activity is an unending stream, a dollar of tax revenue deferred is a dollar never collected.) It is fair to say that classical analysis—and the common sense opinions based on it—significantly underestimates, the importance of tax deferral. *See e.g.*, Andrews, *supra*, 87 Harv. L. Rev. at 1123.

2. Thus, for instance, the leading depreciation cases were decided under a statutory standard no more definite than that "a reasonable allowance" must be made for obsolescence or wear and tear. *Fribourg Navigation Co. v. Comm.*, 383 U.S. 272 (1966); *Massey Motors Inc. v. United States*, 364 U.S. 92 (1960). See also *United States v. Chicago, Burlington & Quincy R.R.*, 412 U.S. 401 (1973) in which the court determined the depreciable basis under a judicially controlled definition of "contribution to capital." The numerous

able income is extensive and the courts have developed an expertise commensurate with their responsibilities.

Many of the most important presumptions of the federal income tax were adopted from accounting practices. See, *e.g.*, *Jennery v. Olmstead*, 36 Hun. 536 (N.Y. Sup. Ct. 1885), *aff'd* 105 N.Y. 654, 13 N.E. 926 (1887), which is the best judicial explanation found of why unrealized appreciation is not now considered taxable income. On the other hand, some of the clearest judicial rules of tax accounting differ from the procedures which accountants require in reporting business income for financial purposes under generally accepted accounting principles.[3] It has been observed that:

capitalization cases have been decided under the standard of section 162 allowing an "ordinary and necessary" business expense (*See, e.g., Comm. v. Tellier*, 383 U.S. 687 (1966) (where the court restricted the function of the term "ordinary" to capitalization questions)) or the term "improvement" in section 263(a). See, *e.g., Comm. v. Idaho Power Co.*, 418 U.S. 1 (1974). The leading cases defining what may be deducted under accrual tax accounting were decided under no more definite a standard than the term "accrual." *Dixie Pine Products Co. v. Comm.*, 320 U.S. 516 (1944); *Brown v. Helvering*, 291 U.S. 193 (1934); *United States v. Anderson*, 269 U.S. 422 (1926).

3. A catalogue of the major differences between financial and tax accounting is found in Cannon, Tax Pressures on Accounting Principles and Accountant's Independence, 27 ACCOUNTING REV. 419, 420 (1952); Reimer, Major Differences Between Net Income for Accounting Purposes and for Federal Income Taxes, 23 ACCOUNTING REV. 305 (1948) and the more extensive Smith and Butters, BUSINESS AND TAXABLE INCOME (1949). The Securities Exchange Commission recently adopted rules requiring increased disclosure by reporting companies of their differences between book and tax income. Securities Act of 1933 Release No. 5541 (Nov. 28, 1973). While no comprehensive measurement has been made using the new disclosures of the dollars involved in the difference between financial and tax income, partial analyses indicate that the differences are economically very significant. See 6 TAX NOTES at, *e.g.*, 16, 34, 148, 306 (General Machinery Companies), 393 (1978) (difference between statutory tax rate on financial income and actual tax rate analyzed for some industries).

Tax divergence from financial accounting is not without its critics. Thus, the National Association of Manufacturers, *amicus* here for petitioners, has lobbied before Congress to make financial accounting conclusive for income tax purposes. Statement of National Association of Manufacturers, 1 HEARINGS BEFORE WAYS & MEANS COMM. ON GENERAL REVENUE REVISION, 83 Cong., 1st Sess. at 598 (1953). A more moderate critic is Hahn, Methods of Accounting: Their Role in Federal Income Tax Law, 1960 WASH. U.L. Q. 1 (1960)(concluding that accounting, within accepted limitations, is capable of some greater utility in the administration of the income tax laws).

"[t]he courts have zealously guarded their own power and that of the Commissioner to determine taxable income without regard to accounting rules prescribed by other . . . federal and state regulatory bodies. . . . [I]n the event of varying criteria, the Supreme Court's decision in *Old Colony R.R. v. Commissioner* left no doubt that taxable income was not to be determined by alien artists:

> 'The rules of accounting enforced upon a carrier by the Interstate Commerce Commissioner are not binding upon the Commissioner, nor may he resort to the rules of that body made for other purposes for the determination of tax liability under the revenue acts.' [284 U.S. at 562]." Hahn, Methods of Accounting: Their Role in Federal Income Tax Law, 1960 WASH. U.L.Q. 1, 38 (1960).

The courts have refused to make generally accepted accounting principles binding for tax purposes because of the need for consistent, equitable and administrable tax rules. "Generally accepted accounting principles" do not provide the enforceable standards needed for the Federal Income Tax.

> "There is some reason to believe that this phrase—'generally accepted accounting principles'—suggests to the ordinary reader the existence of some authoritative code of accounting, which when applied consistently will produce precise and comparable results. The appearance of precision is strengthened by the reporting of net income in exact dollars and cents, instead of rounded approximations.
>
> "Now, we accountants know that 'generally accepted accounting principles' are far from being a clearly defined comprehensive set of rules which will insure identical accounting treatment of the same kind of transaction in every case in which it occurs.

> . . . [W]e all know that in some areas there are equally acceptable alternative principles or procedures for the accounting treatment of identical items, one of which might result in an amount of net income reported in any one year widely different from the amount an alternative procedure might produce. . . .
>
> Yet, I suspect it would come as something of a shock to some people to realize that two otherwise identical corporations might report net income differing by millions of dollars simply because they followed different accounting methods and that the financial statements of both companies might still carry a certified public accountant's opinion stating that the reports fairly presented the results in accordance with 'generally accepted accounting principles'." Eaton (former President of AICPA), Financial Reporting in a Changing Society, 104 J. OF ACCOUNTANCY 25, 26-27 (Aug. 1957).[4]

Thus, as one accountant has succinctly put it, "we [accountants] are quite prone to define 'generally accepted' as 'somebody tried it.'" Cannon, Tax Pressures on Accounting Principles and Accountant's Independence, 27 ACCOUNTING REVIEW 419, 421 (1952), *Accord,* Cox, Conflicting Concepts of Income for Managerial and Federal Income Tax Purposes, 33 ACCOUNTING REVIEW 242 (1958); Arnett, Taxable Income v. Financial Income: How Much Uniformity Can We Stand?, 44 ACCOUNTING REVIEW 482, 492 (1969).

While these variances may be acceptable for financial purposes, they are intolerable in the tax system. Two taxpayers who have identical activities in the year and identical ability to pay ought to pay the same amount of tax. Ultimately, the determination of business taxable

4. For a graphic criticism of the variability in accounting for identical companies, see Federal Trade Commission, ECONOMIC REP. ON CORP. MERGERS 120, 127-131 (1969).

income is a determination of the allocation of the given tax burden, and underpayment by one taxpayer will require the relative overpayment of tax by another. Accordingly, uniform treatment of taxpayers and uniform reporting of income is simply more important for federal income tax purposes than uniform treatment apparently is for financial purposes.

A part of the problem of variability is that accountants commonly accept errors in the determination of business income because of longstanding accounting conventions which make little or no sense for tax purposes. Accountants believe in the comparability of income statements over a series of years so that consistency of accounting methods between years has been raised to a fundamental principle. *See, e.g.,* Kieso, Mautz and Mauer, INTERMEDIATE PRINCIPLES OF ACCOUNTING, 52 (1969); Easton & Newton, ACCOUNTING AND THE ANALYSIS OF FINANCIAL DATA 134-135 (1958). Thus, if a company has followed an accounting practice consistently for a number of years, the practice becomes acceptable even though it is a serious departure from normal accounting. By contrast, the Internal Revenue Service accepts tax on non-recurring windfalls[5] that could not possibly be made comparable to a taxpayer's income in any past or future year. For tax purposes consistency between years is less important than consistency between taxpayers. Secondly, under the convention of conservatism, "accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income." Accounting Principles Board, Statement No. 4 ***Basic Concepts and***

5. *See, e.g., Commissioner v. Glenshaw,* 348 U.S. 426 (1955); *Cesarini v. United States,* 296 F. Supp. 3 (N.D. Ohio 1969) (found property). See, Comment, Taxation of Found Property and Other Windfalls, 20 U. CHI. L. REV. 748, 753 (1953) (no policy basis to distinguish salaries and windfalls).

Accounting Principles, paragraph 171 (1970). *See also*, Sterling, Conservatism: The Fundamental Principle of Valuation in Traditional Accounting, ACABUS, No. 2, 109 (Dec. 1967). This convention, however, is questionable for tax purposes:

> "[I]t is probably safe to say that most American businessmen are now 'talking poor' except in the somewhat uncommon cases that involve rigging the statements with the hope of unloading the business on the unwary who do not themselves employ accountants to look into matters. Certainly the sharp rise in income tax burden has, among other things, had the effect of reducing what formerly was often an unbearable braggadocio. Accountants are now well equipped to resist optimism with regard to profits and value increases. Their defenses against wholesale asset write-downs are—to be charitable—spotty, and the pressures are now almost universally beating against these weak defenses. Devine, Loss Recognition, 6 ACCOUNTING RESEARCH 310, 311 (1955).

Finally, the sins of accountants can sometimes be rectified by disclosure in the footnotes to the income statement. See Myers, Footnotes, 34 ACCOUNTING REVIEW 381 (1959). For tax purposes, however, a tax return that allowed taxable income to be reported in footnotes but not in the computation of tax liability would wreak havoc upon the federal system of self-assessment of taxes.

Accounting errors, if binding for tax purposes, would result not just in random variances in tax, but in systematic deferral in the reporting of income and taxes. Underlying all of the authoritative opinions of the American Institute of Certified Public Accountants is the recognition that the financial accounts of a company are primarily the responsibility of management. Accounting Principles Board, Accounting Research Bulletin No. 43, *Introduction*, paragraph 11 (1953). Tax rules by contrast cannot leave a taxpayer to determine his own taxes by say-so: No self-respecting people could allow their taxes to be collected on the basis of 'willingness to pay.' Moreover, whatever the responsibilities of the accountants to the general public, the accountants themselves recognize that the approval of the accountant is no barrier to the under-reporting of income. "The practicing accountant is duty-bound to assist his client in arriving at the most favorable way of measuring income for tax purposes." Cox, Conflicting Concepts of Income For Managerial and Federal Income Tax Purposes, 33 ACCOUNTING REVIEW 242, 243 (1958). "He, too, is graded at least in part on taxes—the taxes he saves for his client." Cannon, Tax Pressures on Accounting Principles and Accountant's Independence, 27 ACCOUNTING REVIEW 419, 426 (1952).

Blind adoption of financial accounts for purposes of determining tax would have the primary and immediate effect of distorting financial reporting. The possibilities of tax savings would place unbearable pressure on the accountants to change financial practices to step up deductions and defer income.[6] Since tax is usually the most important factor influencing the method of reporting income, businesses would inevitably adopt less than ideal accounting practices in order to gain tax advantage over their competitors. This would be bad for the accounting profession and bad for the tax system.

The courts have rejected financial practices for tax purposes in part in order to achieve or improve objective and administrable standards to determine business income. A mass national tax requires that the amount of taxable

6. Kurtz, Can the Accounting Profession Lead the Tax System, 126 J. ACCOUNTANCY 66, 69 (September 1968); Lent, Accounting Principles and Taxable Income, 27 ACCOUNTING REV. 479, 485 (1962).

income be defined with enough certainty to avoid endless disputes as to the amount which is owed. Thus, for instance, this Court in *Brown v. Helvering*, 291 U.S. 193 at 201 (1934) denied a deduction for an estimated expense, which an accountant would be required to accrue, because "[e]xperience taught that there is a strong probability [that the contingencies giving rise to the liability will occur]. But experience taught also that we are not dealing with certainties." The tax accounting rule avoids protracted controversy over the real likelihood of the contingency or the accuracy of the estimates. Here as elsewhere, tax accounting "is easier to administer because it involves fewer subjective judgments and estimates." Schapiro, Tax Accounting for Prepaid Income and Reserves for Future Expenses, 2 *Compendium of Papers on Broadening the Tax Base Submitted to the Ways & Means Committee*, 86th Congress, 1st Session 1133, 1142 (1959).

In sum, the Commissioner and the courts must review a taxpayer's books to determine whether the taxpayer's determination of taxable income is correct, even where the taxpayer reports the same income for financial purposes and under methods within the range of generally accepted accounting principles. Tax accounting is too important to be left to the accountants.

II. While the lower of cost or market method is an acceptable method of accounting for inventories for tax purposes, the Commissioner is not therefore bound to accept every undervaluation of inventory claimed by management.

Inventory accounting is a kind of capitalization. Inventory accounting allows a deduction for the basis of goods sold, but not for the basis of goods retained. The

rule is like the rule that a taxpayer gets tax recognition for the cost of corporate shares he sells during the year, but not for the cost of shares or other nondepreciable assets he keeps. Since it is far easier to keep track of inventory goods held at the end of the year than to identify the cost of each good as it leaves inventory, the inventory deduction—cost of goods sold—is computed by the process of elimination: Cost of goods sold equals the cost of all goods (including goods acquired and inventoried in prior years) minus the costs in inventory on hand at the close of the accounting period. Closing inventory is capitalized and everything else is deducted. For tax purposes a taxpayer wants a low value or a write down for closing inventory because that means less of his expenditures are capitalized and that more of his expenditures reduce taxable income immediately.

Capitalized costs are carried as asset accounts on the balance sheet to future years when they become an expense charged against future income. Accountants, however, are reluctant to carry costs on the balance sheet across to future income statements unless the "asset" has a value equal to the amount of the account—even if the costs relate most plausibly to future periods. Thus under the lower of cost or market method for accounting for inventory, which is the method petitioner herein used, closing inventory is written down to its net realizable value if such value is lower than original cost. As explained by the AICPA,

> "[h]istorically, managers, investors, and accountants have generally preferred that possible errors in measurement be in the direction of understatement rather than overstatement of net income and net assets. This has led to the convention of conservatism, which is expressed in rules adopted by the profession as a whole such as the [rule] that inventory should be measured

> at the lower of cost and market . . . [This rule] may result in stating net income and net assets at amounts lower than would otherwise result from applying the pervasive measurement principles [such as matching of expenses with income]. Accounting Principles Board, Statement 4, Basic Concepts and Accounting Principles at paragraph 171 (1970).

Writing down inventory assets to lower value has been criticized, especially by more academically inclined accountants, as inconsistent with the rule that unrealized gains are not taken into account,[7] and as producing undue fluctuation in income between the year of write down and the later year of sale.[8] However, as indicated by petitioner's five expert accounting witnesses at trial, the lower of cost or market is a fully acceptable method. It has the "almost unanimous support" of accounting practitioners.[9] In any event, the lower of cost or market method has been an authorized method for tax purposes since 1917 when the first inventory regulations were adopted[10] and the controversy in this case does not involve the theory of the method or its general validity for tax purposes.

However, while the lower of cost or market method is valid in theory, application of the method has been subject to tremendous abuse. The method requires determinations of the market value of inventory. Consequently, without being inconsistent with the theory of method,

7. Hoffman and Gunders, INVENTORIES: CONTROL, COSTING AND EFFECT UPON INCOME TAXES at 162 (2d Ed. 1970); Paton, dissenting from the original ARB No. 29 at point 4 (doubting that value is significant when prices are falling but deserves no notice when prices are advancing); Gilman, ACCOUNTING CONCEPTS OF PROFIT (1939) (a "heads I win, tails you lose" rule).

8. Hoffman and Gunders, *supra* note 7, at 162-163; Smith and Butters, BUSINESS AND TAXABLE INCOME at 101 (1949); Sterling, Conservatism: The Fundamental Principle of Valuation in Traditional Accounting, 3 ABACUS, No. 2, 109, 110-111 (December 1967).

9. Barden, THE ACCOUNTING BASIS OF INVENTORIES, AICPA ACCOUNTING RESEARCH STUDY No. 13 at 102. (1973).

10. T.D. 2069 (Dec. 19, 1917).

management can cheat if it wishes. Accountants themselves have recognized that determinations of value are manipulable in computing the financial income for which they are responsible.[11] It is, however, for tax purposes that the manipulations of value have become truly scandalous. These manipulations are so severe that it has been said that "if the federal government wanted to pay off the national debt and balance the budget all it needed to do was audit inventories for federal income tax purposes." Skinner, Inventory Valuation Problems, 50 TAXES 748 (1972). While this statement is undoubtedly an exaggeration, the comments of other knowledgeable observers confirm the abuse. See, B. Bittker and L. Stone, FEDERAL INCOME ESTATE AND GIFT TAXATION 843 (4th edition 1972) (income is sometimes systematically understated by deliberately low estimates of closing inventories, a practice that may become a form of fraud); Schwaigart, Increasing IRS Emphasis on Inventories Stresses Need for Proper Practices, 19 J. TAXATION 66, 69 (1963). (Note also the title of Swan & Marcus, Current Developments in Tax Accounting: Inventories (Now You See Them, Now You Don't), 28 S. CAL. TAX INST. 493 (1976).) The practice of inventory write downs in an endeavor to avoid tax liability apparently has been a practice since bookkeeping was developed in Renaissance Italy. Hoffman and Gunders, INVENTORIES: CONTROL, COSTING AND EFFECT UPON INCOME AND TAXES 146 (2d ed. 1970). In 1961 the Secretary of the Treasury testified that the President had directed the Internal Revenue Service to give increasing attention to inventory reporting as [illegible] area of tax avoidance, noting especially that closi[illegible]nventory could be

11. Paton, The Cost Approach to Inv[illegible]s, 72 J. OF ACCOUNTANCY 300, 303 (1941) (lower of cost or ma[illegible]allows management to fudge costs and doctor accounts to protect the[illegible]ing of future profits by understating inventories); Husband, Anoth[illegible]ok at Cost or Market, Whichever Is Lower, 21 ACCOUNTING REV. 1[illegible]120 (1946) (lower of cost or markct results in profit manipulation.)

manipulated by undervaluation under the lower of cost or market method. The Secretary, however, did not recommend legislation for the reason that abuses could be reached by administrative action under current law. Statement of Secretary Dillon, Hearings on President's Tax Message of Aprol 20, 1961, before the House Ways and Means Committee, 87th Congress, 1st Session, 295-96 (1961).

It is because of the history of manipulation that the inventory statute and the regulations based on it necessarily commit such a high degree of discretion to the Commissioner to approve and even prescribe closing inventory accounts and, further, require a strict standard of evidence to justify closing inventory write downs. As a general rule the taxpayer has the burden of proof in tax cases—necessarily so since the taxpayer has control of all evidence and could, in the absence of such a rule, defeat the Internal Revenue Service by withholding that evidence. Section 471, the inventory statute, goes beyond this general burden and requires that reporting of inventories must be on such basis "as the Secretary may prescribe." Internal Revenue Code of 1954, §471. As one court has observed, "The determination of the valuation of inventories, including therein all items entering into the basis, . . . is expressly confided to the Commissioner." *Montreal Mining Co.*, 2 T.C. 688, 694 (1943).

While the regulations under section 471 have not used the full statutory authority to prescribe specific closing inventory accounts for a taxpayer, they do require objective evidence of value to justify a write down below cost. Treasury Regs. §1.471-2(c) required that inventory carried at a lower than cost "market" be valued from "bona fide selling prices." "Bona fide selling price means actual offering of goods during a period ending later than 30 days

after inventory date." Treasury Regulations §1.471-2(c). The courts have routinely upheld the evidentiary requirements of the regulations. *Pierce Arrow Motor Car Co. v. United States*, 11 F. Supp. 60, 63 (Ct. Cl. 1935) (marked down sales were after close of inventory period); *Elder Manufacturing Co. v. United States*, 10 F. Supp. 125, 129 (Ct. Cl. 1925) (failure to meet evidential burden); *Melvin Goodman*, T.C. Memo 1971-226 (insufficient proof that market value was accurately reflected through annual reductions of cost price by a fixed percentage); *National Fireworks, Inc.*, T.C. Memo 1956–1 (insufficient evidence as to how inventory was valued to permit a writedown).

Certainly no case has allowed a write down of inventory on a mere opinion of management, no matter how "careful" or "experienced" management has tried to appear. Even *Space Control, Inc. v. Commission*, 322 F.2d 144 (5th Cir. 1963) and *E.W. Bliss Co. v. United States*, 224 F. Supp. 374 (N.D. Ohio 1963), *aff'd* 351 F.2d 449 (6th Cir. 1965), on which petitioner relies, while erroneously sloughing aside the requirement of showing of bona fide selling prices required by Treasury Regs. §1.471-2, still maintained a controllable standard. These cases allowed write downs only for goods identified to contracts for a fixed price; items not so identified were not allowed to generate a deductible write down.

The courts early came to the conclusion that tax write downs under estimates or conventions such as the petitioner used in this case could not be allowed for tax purposes. See T.B.R. 48, 1 Cum. Bul. 47 (1919), where in a carefully reasoned opinion the Board of Tax Advisors recommend disallowing an inventory write down using a convention for estimating and averaging value.[12] Since

12. The Board of Tax Advisers was a quasi-judicial authority which was the precedessor to the Board of Tax Appeals. See Dubroff, The United States Tax Court: An Historical Analysis, 40 Albany L. Rev. 7, 44-45 (1975).

1919 this lead has often been followed. *See, Harry P. True*, 6 B.T.A. 1042 (1927) (inventory write-down disapproved where evidence of lower market value consisted entirely of testimony of three witnesses, two of which were associated with the firm involved); *Appeal of Otto Altschul*, 5 B.T.A. 53 (1926) (write-down disallowed where taxpayer attempted to deduct arbitrary amount from cost price); *Appeal of Kleeman Dry Goods Co.*, 2 B.T.A. 369 (1925) (write-down disallowed where market value as computed by taxpayer consisted of arbitrary percentage of cost); *Ralph Ellstrom* T.C. Memo 1955-91 (application of flat rate to finished and unfinished products did not accurately reflect market value of closing inventory).

It is because of this great potential for abuse that this Court must affirm the Commissioner's power to require as high a standard of evidence as he feels necessary, regardless of the standard which a taxpayer may feel is sufficient for bookkeeping purposes. Since inventory valuation operates in a system which generally does not allow recognition of unrealized losses, even those taxpayers who are unable to prove declines in value which have in fact occurred are not treated unjustly; they are just brought in to line with the more general rule that unrealized gains and losses are not taken into account for tax purposes until sale or abandonment.

Since the tax accounting rules are so strict, it is not surprising that inventories are commonly reported differently for tax and financial purposes. Thus, Treasury Regulations §1.471-2(f) prohibits deducting from inventory a reserve for price changes or estimates in value.

> "The restriction against the deduction of an inventory reserve is merely one specified example of the general policy not to allow reserves to be deducted from income.... In an early case, ... the Board [of Tax Appeals] stated . . . : 'In this instance good accounting and the statute may not be in strict accord, since Congress may with entire fairness tax what a conservative prudent businessman may wish to hold in reserve." Smith and Butters, BUSINESS AND TAXABLE INCOME, 99 (1949) quoting *Appeal of Consolidated Asphalt Co.*, 1 B.T.A. 82 (1924).

Treasury Regs. §1.471-11(c)(2)(i) specifies indirect production costs which must be included in inventory regardless of their treatment by the taxpayers in his financial report, whereas generally accepted accounting principles allow many of these costs to be expensed directly.[13]

Such differences are to be expected under the statute. Section 471 requires that the taxpayer's method "most clearly reflect income," according to the prescription of the Secretary, as well as be in accordance with "the best accounting practice." The requirement of "clearly reflect income" is neither redundant nor, given the extensive case law upholding the Commissioner's application of the standard, is it trivial. *See, e.g., Burck v. Commissioner*, 533 F.2d 768 (2d Cir. 1976); *Commissioner v. Kuckenberg*, 309 F.2d 202 (9th Cir. 1962); *Williamson v. United States*, 292 F.2d 524 (Ct. Cl. 1961); *Cole v. Commissioner*, 64 T.C. 1091 (1975) on appeal to Ninth Circuit.

In sum, "[e]ven if the accounting method used by the taxpayer is consistent with generally accepted accounting principles, it may not so clearly reflect income as to be binding upon the Commissioner." *Cole v. Commissioner*, 64 T.C. 1091, 1103 (1975), on appeal to Ninth Circuit. *See also, e.g., Mooney Aircraft, Inc. v. United States*, 420

13. Thus, for instance, Hoffman & Gunders, *supra* 7 note at 137, support direct expensing of maintenance and of vacation pay, whereas Treas. Regs. §1.47-11(c)(2)(i) requires inventorying, regardless of financial reporting.

F.2d 400 (5th Cir. 1969). To hold, as petitioner urges, that inventory accounts prepared under generally accepted accounting practices were conclusive for tax purposes would tear open the fabric of existing law for the benefit only of abuse and manipulation.

III. Petitioner's claimed write down is a special abuse case because management offered no proof to support its opinion and apparently did not itself know the value of its inventory, because the accounting convention which management adopted is self-refuting and because deduction of excess production is erroneous in theory.

Whatever the impact of this Court's decision on the law of inventory valuation, petitioner's write down of inventory in the instant case was clearly a special abuse because petitioner offered no evidence in support of management's opinion of inventory value and because petitioner's method of accounting was erroneous in result and in theory.

A. *The evidence petitioner presented to support its accounts did not go toward proof of value of its inventory and is not sufficient to protect against manipulative undervaluation*

Petitioner offered no evidentiary support for its inventory write down—or for that matter for its claimed addition to its bad debt reserve in excess of that demonstrated by historical experience [13a] —other than the testimony of man-

13a. While amici here have not briefed the bad debt issue, they take the position that a taxpayer's experience is a better guide as to the necessary bad debt reserves than its management's claims and that the Black Motor Car formula is the best administrable test, absent the most extraordinary circumstances.

agement that in its opinion the write down was justified. Petitioner did not attempt to demonstrate that the value of any parts was less than cost. In fact, any of petitioner's inventory actually sold must have been sold for a price considerably in excess of cost. These are very valuable repair parts. Petitioner holds an absolute monopoly on unique parts and each part holds the underlying power tool as a hostage.

In spite of the honorific descriptions which petitioner in its brief applied to management's opinion, still petitioner presented none of the facts from which a reasonable person could reach the determination that management's opinion was correct or even that it was well founded. Management did not even take the trouble to apply its "best estimate" (Petitioner's Brief at 11) or "careful and detailed analysis" (Petitioner's Brief at 7) or "long manufacturing experience" (Petitioner's Brief at 7) to individual items or narrow lines. Instead there was a blanket estimate of salability which was applied to every item in petitioner's inventory.[14] Management's opinion for tax purposes had no correlation to business reality since petitioner did not at any time sell or offer to sell its repair parts at the allocable market value asserted for tax purposes.[15]

Even the testimony of petitioner's President is weak support for petitioner's claims. Mr. Collins was unwilling to say anything more helpful to his position than that potential technological and market changes made it unreasonable to keep at cost as much as two year's supply of repair parts. (Petitioner's Brief at 11). He did not testify as to actual value. Since petitioner admitted that

14. See a criticism of such blanket estimates in Devine, Loss Recognition, 6 ACCOUNTING RESEARCH 310, 316 (1955). See also cases cited pp. 17-18 *supra*.

15. See *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (transactions without business purpose need not be respected for federal tax law).

it was unaware of the amount of its inventory which was sold in a year's time from its Cincinnati and LaGrange Park plants (64 T.C. at 159), it appears that petitioner simply does not know the value of much, if not all, of its inventory.

If petitioner had presented five experts in the valuation of parts or even five dealers in spare parts, instead of five expert accountants this case would have come to this Court in a different posture. Although appraisals are not conclusive nor sufficient under Treasury Regulations §1.471-2 nonetheless, the taxpayer could have at least shown a good faith effort at valuation, instead of the arbitrary procedure that it used. Petitioner's accountants have no special expertise in appraisals. Moreover, the Tax Court opinion was rendered eleven years after the taxable year in question and had taxpayer's estimates been vindicated by later experience that experience would surely have been offered in evidence.[16]

The Court is not dealing in this case with *de minimis* figures for which rough justice must be sufficient to keep the system running. Petitioner's claim is for almost a million dollars of write downs. If there was better evidence to support its opinion, then it should have been produced.

B. *Petitioner's convention for writing down inventory did not attempt to measure the value of any parts in its inventory and is self-refuting for parts sold more than a year after the write down*

Rather than attempt to determine the market value for the parts in its inventory, petitioner in its write downs under the lower of cost or market method arbitrarily labelled

16. "While subsequent events are not determinative of a fact on a given date . . . that which occurred . . . confirms what would have been reasonable at that time." *Space Controls, Inc. v. Comm.*, 322 F.2d 144, 155 (5th Cir. 1963).

some of its inventory as salable at full cost, some salable at 25 or 50 percent of cost, and some as not salable at all. Under the convention which petitioner used to generate the write down, one year's supply of parts was retained in final inventory at cost; a second year's supply was written down, half by 75 percent and half by 50 percent; anything over two year's supply was written off. The actual sales of repairs for the year of the write down defined one year's supply under the convention. Where Petitioner had two year's supply or more, the procedure had the same effect as simply keeping 1.375 year's supply worth of parts at cost and writing everything else off. Petitioner made no empirical study of salability; for every product the same 1.375 year's supply was kept at cost and the rest written off. This, despite wide variations in salability.

Under petitioner's own assumptions the convention is self-refuting for any part sold more than a year after the write down. Assuming the definition of one year's supply proved accurate, any inventory to be sold more than two years after the write down had a zero basis: when sold, its cost would have already been deducted two or more years before. Thus, a sale of such parts for any price would generate a gain—a gain not arising from any increase in value but solely because of the artificial deductions taken two or more years earlier. For parts sold ~~within~~ more than a year but less than two years after the write-down, the convention would leave the parts with an average basis equal to 37.5 percent of the cost (62.5 percent average write-down) but since the taxpayer offered no evidence of any sales below costs, it would appear that even those sales would generate the gains that identify the prior artificial deductions.

Of course, most conventions can produce a correct result by accident.[17] Under the petitioner's method of

17. Even a broken watch has the correct time twice a day.

computation, if the total amount of repair parts (for any given part) ever sold were sold for an aggregate net equal to 137.5 percent of the sales of that part in 1964, then where the petitioner started with two or more year's supply the convention would, by accident, have given a value equal to the fair market value of the supply. Petitioner presented no evidence from which one can ascertain whether the convention coincidentally came out in such a fashion, but one would intuitively conclude that is extremely unlikely that annual sales would drop off fast enough to make the convention come out right.

Most importantly, however, it is apparent that petitioner's accounting convention contradicts itself because even if the sales dropped off as quickly as needed to justify the 1.375 value, petitioner would make further write offs in the following years by using the new, lower sales figure to define one year's supply. (Petitioner's Brief at 9, footnote). Thus, even when the convention could be correct, it refutes itself by redefining one year's supply.

In addition to the inventory convention for excess inventory that generated $744,000 worth of write-downs, taxpayer took "supplementary" write downs of 50 percent, 10 percent or 5 percent of inventory where it didn't even have enough information to apply the convention (64 T.C. at 159). Consequently, petitioner attempted to claim yet another $160,000 in deductions. Percentage write downs do have the advantage for taxpayer here in that they are not self-refuting as is the primary convention, but are merely arbitrary and unsupported.

C. *Petitioner intentionally produced more inventory than it thought it could sell and allowing it to deduct the overhead costs allocated to such excess inventory would be to allow petitioner a manipulable tax loss in excess of any economic loss petitioner has suffered*

Even if petitioner's management were totally accurate in its valuation and even if Thor Power's convention were not self-refuting, it would nonetheless be inappropriate to allow petitioner's write offs for overproduction of inventory. There was not necessarily any change in 1964 in the circumstances affecting the value of petitioner's inventory, other than a change in management. Whatever loss petitioner claimed in 1964 was apparently built into the inventory under petitioner's method the moment that inventory was produced, since petitioner deliberately produced the excess which it is writing off.

If writing off excess inventory were deemed legitimate for tax purposes any company could, as soon as it completed its production run of inventory parts, conclude that most were unsalable under its best estimate. The company, by allocating its production cost (including overhead) to the excess, could deduct most of its production cost while retaining its full supply of inventory for profitable sale.

To illustrate, assume that a product could be sold for $100x but that most of its cost is for overhead costs such as design, tooling, and employee training. The costs of setting up the assembly line are prohibitive if the line is closed down but once the assembly line is running then the marginal costs (supplies and labor) of the product are only $1x. Using its best estimate, the company may conclude that it can only sell 50 bushels—"a year's supply"—

of its product, but it believes that there is a 100-1 chance of selling 1250 bushels—25 years' supply within a reasonable time. Without any tax planning, the company would rationally produce 25 times more inventory than it honestly thinks it will sell in order to take advantage of the most favorable possibilities, since the cost of $1x per item is worth the 100-1 chance of recovering $100x on the sale of the last product in inventory. If writing off excess inventory were legitimate for tax purposes, then as soon at it completed its production run, the company would reasonably determine that only 1/25 of its supply was "salable" under its best estimate. The company would allocate 24/25 or 96 percent of its total cost of the product (including over head) to the excess product and write off the 96 percent. Its "method" then, would be to deduct 96 percent of its cost of the product as soon as it makes them, even though the company retains its full supply of product in inventory and expects to make money on every unit it sells. Since the company was rational in making the "excess" 24 years supply—the cost was justified by the possible but less than most likely prospects—it is improper for it to claim that the excess production is an economic loss. If such non-economic losses were recognized for tax purposes, management of many companies would inevitably always produce such excesses just to deduct the lion's share of their production costs. In any event, absent a showing here that petitioner's originally rational decision to produce the excess proved to be irrational, petitioner is not entitled to any loss deduction here.[18]

18. Treas. Reg. §1.471-2(c) authorizes a write-down to value for under the lower of cost or market for "any goods in inventory which are unsalable at normal prices . . . because of damage, imperfections, shop wear, changes of style, off or broken lots or other similar causes." Petitioner's claimed loss is not within the enumerated cases nor from "other similar causes" since the phrase refers to changes in the value of the inventory since production and not to losses such as this one inherent in the petitioner's accounting method as soon as normal inventory leaves the production line.

Carrying large entirely unsalable inventory on the balance sheet at its average cost may indeed be troublesome accounting. Perhaps most of the extra overhead costs of production could, under some future accounting practice, be assigned to the inventory reasonably expected to be sold—except that inventory is fungible and estimates of the probability of selling various quantities are a continuous function.[19] In any event, even if the salable supply—whatever that means—were to carry a higher share of the total cost, petitioner here would not be helped. Petitioner still held its salable supply that it said it needed in its closing inventory and writing off the excess supply would justify only writing off the trivial marginal costs of the excess. The overhead costs would be allocated to parts petitioner admits should not be written down and such costs would not be deducted.

In any event, as indicated by the paucity of analysis in the accounting literature, the problem of accounting for intentional overproduction of inventory is simply a problem which the accounting profession has not analyzed. Certainly it has reached no consensus on the matter. If the court were to defer to the accounting profession to solve the problem, it would be deferring to a vacuum.[20]

19. Of course, it might be difficult to determine whether to assign the higher share of overhead costs to the first 100 units, the first 10,000 units or the first one million units.

20. *See*, Gunn, The Requirement that a Capital Expenditure Create or Enhance an Asset, 15 B.C. IND. AND COMM. L. REV. 443, 464 (1974) (criticizing the Tax Court's reliance on expert accounting testimony and accounting literature, in *Fort Howard Paper Co.*, 49 T.C. 275 at 285-86 (1967), whereas the accountants have in fact left the question open); Arnett, Taxable Income vs. Financial Income: How Much Uniformity Can We Stand? 44 ACCOUNTING REV. 482, 493 (1969) (criticizing accountants who ask for legislative changes to conform tax rules to nonexistent standards of generally accepted accounting principles).

CONCLUSION

To prevent abuse by which undervaluations of inventory relieve certain taxpayers of their fair share of the burden of tax, thus shifting their burden to others, amici respectfully urge this Court to affirm the decision below in its disallowance of a deduction for a writedown of inventory.

Respectfully submitted,

/s/ Eric Neisser
ERIC NEISSER
15 Washington Street
Newark, New Jersey 07102
(201) 648-5687

/s/ Calvin H. Johnson
CALVIN H. JOHNSON
15 Washington Street
Newark, New Jersey 07102
(201) 648-5065

Attorneys for Amici Curiae, Taxation With Representation Fund and Tax Reform Research Group.

CERTIFICATE OF SERVICE

I hereby certify that on July 24, 1978, I served three copies of this Amicus Curiae Brief for the Taxation With Representation Fund and for the Tax Reform Research Group, upon each of the parties to this proceeding by depositing the same, enclosed in a sealed envelope with first class postage thereon fully prepaid, in a United States mail box at Newark, New Jersey, addressed to the attorneys for the parties as follows:

Mark H. Berens, Esq.
Lee N. Abrams, Esq.
John E. Allen, Esq.
Douglas A. Poe, Esq.
Suite 1955
231 South LaSalle Street
Chicago, Ill. 60604
Attorneys for Petitioner.

Honorable Wade Hampton McCree, Jr.
Solicitor General of the United States
U.S. Department of Justice
Washington, D.C. 20530
Attorneys for Respondent.

Calvin H. Johnson
Attorney for the Taxation With
Representation Fund and for Tax
Reform Research Group.